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MODERNIZATION OF THE GLASS-STEAGALL ACT

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

THE HISTORY OF THE GLASS-STEAGALL ACT AND ITS CURRENT RELEVANCE IN THE FUTURE OF THE NATION'S FINANCIAL SERVICES INDUSTRY

JULY 30, 1987

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MODERNIZATION OF THE GLASS-STEAGALL ACT

THURSDAY, JULY 30, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, Sasser, Sanford, Graham, Wirth, Garn, Heinz, D'Amato, Hecht, Bond, and Karnes.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

I'm delighted to see my good friend and colleague, Senator Riegle, who is chairman of the Securities Subcommittee here, because I'm going to have to leave after I read my opening statement for just a few minutes and then I intend to return within a ½ hour or so.

Today we address what is probably the most contentious issue facing the American financial sector, the separation of banking from securities. This separation is embedded in the Glass-Steagall Act.

Glass-Steagall is an important legal landmark and to some a shrine. Times have changed, as my friend and colleague, Jake Garn, often reminds me. When Carter Glass and Henry Steagall offered the 1933 law, they may not have anticipated cash management accounts, nonbank banks or the Eurobond market. Yet all of these and many other products suggest that the Glass-Steagall separation of banking and other business is perforated.

The question we address in these hearings generally and in today's session in particular is the implication of the perforations. Do they mean that the separation is legally unfeasible? Do they mean Congress should be more vigorous in plugging the loopholes?

The last 6 years the courts and not Congress have crafted the boundaries of bank securities powers. The Supreme Court permitted Bank America to purchase Schwab, a discount brokerage. We have subsequently seen fights over securities registration by banks in other areas.

It's high time for Congress to weigh in on the issue, but we must address the motivation, the potential benefits, and the problems.

Banking profits are sagging currently while securities firms are riding a very profitable wave of corporate mergers. Yet in raw economic size, banks dwarf securities firms. Banks may argue that a handful of securities firms control certain underwriting businesses, but would this concentration really change? Perhaps it may become a handful of banks and securities firms dominating these sectors.

Conflicts are clear. If a bank needs to bail out a shaky borrower, how tempting it would be to underwrite a bond and shift the risk off to the public. Yet bankers can make a good case that these conflicts can be avoided and the case is market-tested. Bankers are underwriting the bonds and securities of corporations in Europe. Aren't there cases, many of them, where banks are both lending to and underwriting securities to the same companies in Europe? If there are, have there been any abuses?

I hope that our witnesses this morning can spell out the abuses and document them.

Today we are privileged to hear from expert historians who can tell us what Carter Glass and Henry Steagall really had in mind, from players and observers of contemporary industry who can shed light on the relevance of their grand old law in today's industry.

I am really deeply indebted to the very high caliber of the witnesses who are appearing before us today and I'm sure we are all going to learn a great deal.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

I appreciate the witnesses you have gathered today for another hearing on Glass-Steagall. Over the last 12 years, 6 of which I was chairman of this committee and 6 of which Senator Proxmire was chairman, the two of us together in those capacities conducted hearings on Glass-Steagall with more than 20,000 pages of testimony.

So I don't know whether we will hear anything new today. I was 1 year old when Glass-Steagall passed. I didn't know either Mr. Glass or Mr. Steagall, but I feel like I know them intimately. I have dealt with Glass-Steagall for so long it's embedded in my bean.

Senator Riegle also knows this subject very well. He was the ranking minority member when Garn-St Germain passed and was very, very helpful in that process. Without him, I don't think we would have been able to get it through.

I do not wish in any way to detract, gentlemen, from your statements on Glass-Steagall, but to make the point that it is time to act. Without suggesting today exactly how we should act, but the chairman indicated that I had said that times have changed. Yes, times have changed since 1933 rather dramatically. Times have changed rather dramatically in the financial services industry in the last 12 years and even in the last 5 years, far, far beyond what I would have anticipated.

Five years ago when I'd make speeches about the need to modernize and change Glass-Steagall and bring it up to date with the real world of the marketplace, people would ask me to predict what I thought the financial services industry would look like 5 or 10 years down the road. My normal reply was, "Well, my crystal ball is not any better than anybody else's and I hate to make predictions."

But sooner or later they would push me into a corner and demand that I describe what I thought it would look like, and so I would. People would say, "Get off the end of your limb, Jake. You're too far out there. You shouldn't be out that far making those rash predictions. You're wrong."

I'd like to tell everybody that I was wrong because I underestimated the speed of change. My wild speeches underestimated and there is no way that I could have anticipated the dramatic changes of the capital markets in this country and particularly the internationalization of the capital markets.

I just couldn't have predicted what took place, and yet we are still dealing with the same basic laws while the marketplace has changed dramatically. And I suppose one of the best illustrations of that change—I represent a relatively small State and a very conservative State, and so a few years ago if I even mentioned repeal of McFadden and interstate banking I might never have been able to return to the State. And yet 1½ years ago the Utah State Legislature unanimously in 1 day, both the House and the Senate and signed by the Governor of our State that day, approved an interstate banking bill with a 2-year trigger, not reciprocity, not regional compacts—January 1, 1988, which is less than 6 months away, any bank that wants to come and buy a bank in Utah or start one in Utah can do so.

So because Congress has been unwilling to act, the courts and the States are taking it into their own hands. The changes are occurring, but they are occurring in a lopsided, quilt pattern across the country without any direction from this body.

So I'm pleased that Chairman Proxmire is holding these hearings and I am pleased that he has made a commitment to move much further than the legislation that we passed or approved yesterday in conference and at the moratorium's expiration next March will try and push Congress into taking action. After all these years, he will certainly have my full support in trying to tone down the special interests, each who always want modernization except for their section of the bill and want their protection left for them but change it for everybody else.

Now the chairman has made a commitment. A majority of the members of this committee have said that this moratorium will not be extended. So these hearings are important and I am hopeful that after more than a decade of inaction Congress will act by next year in order to make some needed changes in Glass-Steagall.

OPENING STATEMENT OF SENATOR RIEGLE

Senator **Riegle**. Thank you, Senator Garn.

I think this hearing this morning is a particularly important one for us and I want to compliment Senator Proxmire for his leadership in crafting the approach to the hearings that we have underway and which today's session are a part.

The action last night of the Banking Conference Committee of the House and Senate to agree upon a bill that the White House will now sign which has in it the recapitalization of FSLIC and other major issues related to financial services, it in fact now puts us on a path to try to make some fundamental decisions about what the future of the financial services industry of this country will look like.

Time is short because the international pressures are building. Internationalization of markets is occurring with major new players coming on the scene in the United States with tremendous capital strength, and it is essential that we decide in a rational way what the future of the financial services industry in this country should look like and I want to say today to all of the interest groups that are parties of interest in this discussion that the clock is now running and the fact that we have this period of time until early next year in which to try to make some fundamental judgments and decisions, it is a period of time which we must fully use and I want to call on each party at interest to see if by talking with their counterparts and sometimes adversaries and competitors in the business if we can't begin to find some basis for a broad private sector consensus as to what should be done in the way of any changes or modifications in the legal structure or in the definitional structure of financial services in the United States.

I expect a new measure of leadership coming out of the private sector that is clearly needed, and I think very profoundly in the national interest. As Jake Garn has said, that involves I think blending the broad sense of the public interest with a view of one's private interests, but recognizing that some movement is going to have to take place here.

We are seeing market-driven movement. We are seeing administrative decision movement out of administrative agencies. We are seeing international competition forcing change. And it seems to me we are now at a point where we need to make a wise collective judgment here in the United States about what the financial services business will look like in the next 10, 20, 30, 40 or years.

So this window in time between now and the early part of 1988 is a period that we must fully use and I again call on every participant to come to that table of discussion and search for ideas and perhaps new concepts as to how we take and work our way to a sound balance that can serve us well in the years ahead.

Our witness list today I think, by calling upon people who have a long and distinguished professional history on the questions of the historic laws that separate banking from commerce and commercial banking from investment banking, gives us an opportunity to broaden the frame of reference in which this debate must take place.

Then our second panel, will have Dr. Henry Kaufman, Martin Mayer and Thomas Johnson. Three very distinguished senior figures who can bring us their thoughts on these issues. But the time for us to start working our way toward some basic judgments is now, and today's effort will help importantly in that regard.

Senator Hecht.

OPENING STATEMENT OF SENATOR HECHT

Senator HECHT. Thank you, Mr. Chairman.

I just have a short statement. I'd like to say, Mr. Chairman, I'm impressed that you've gotten right down to business, as you indicated you would, by holding these hearings and I would like to thank our very distinguished panel for appearing before us today.

As we once again revisit this issue, I must say I am dismayed by those who continue to make this a selfish turf battle. By doing so, the ability of our U.S. financial system to compete both here and abroad is greatly inhibited. We have all heard the facts. Four of the 5 largest banking companies in the world are Japanese. Seven of the 10 and 14 of the 25 largest companies are Japanese, and in 1980 none of the Japanese banks were among the largest 5.

Now if you were a worrier, that is something to worry about. Mr. Johnson, I read your testimony and I think you very accurately sum it up when you state that new powers are not the issue here. I think the issue is far greater than that. It is the future of our Nation's financial services industry.

Thank you, Mr. Chairman. I look forward to hearing from today's panel.

Senator **Riegle**. Thank you, Senator Hecht.

Senator Wirth.

OPENING REMARKS OF SENATOR WIRTH

Senator **Wirth**. Thank you very much, Mr. Chairman.

Just very briefly, gentlemen, we are delighted to have you here. The issues that you will be describing are familiar to all of us. The solutions, unhappily, are not.

As we look at this, we are looking at a series of issues surrounded by an enormous amount of political veto power, a lot of which is sitting in the room today. I hope that we all have the wisdom to avoid the exercise of that power and the wisdom to meet the charter set by Chairman Riegle in his comments earlier this morning.

Thank you very much for being here. We have a very ambitious task ahead of us, probably the most ambitious one that this committee has faced in a long, long time, and I look forward to being part of the solution.

Thank you, Mr. Chairman.

Senator **Riegle**. Thank you, Senator Wirth. At this point I would like to insert into the record, statements of Senators Dixon, Sasser, Sanford, Heinz, D'Amato, and Karnes.

STATEMENT OF SENATOR ALAN DIXON

Senator **Dixon**. Mr. Chairman, I am pleased to be here this morning as the Banking Committee examines the Glass-Steagall Act and other issues related to the banking and securities industries. We have a distinguished group of witnesses before the committee today, and I look forward to hearing their testimony.

Before we begin, however, I would like to make a comment on the conference report on H.R. 27. As I'm sure everyone here knows, we reopened the conference last night in order to include a compromise that Senators Proxmire and Garn, and Congressmen St Germain and Wylie reached with the administration.

I want to take this opportunity to repeat what I said last night: this compromise is far from perfect, but it is one that I can support. Further, I think it is vitally important to avoid a lengthy veto fight. The additional period of uncertainty that battle would create would be good for no one. I congratulate Chairman Proxmire and Senator Garn. I think compromise is far preferable to confrontation, and I wish we would see more compromise in other issue areas. I think the administration was late in coming to the bargaining table, but they did come before it was too late, and I want to congratulate them for finally seeing the wisdom of reaching an accommodation.

H.R. 27, in my view, represents a first step in the process of developing long overdue comprehensive financial services reform legislation. Today's hearing is part of the second step. H.R. 27, if passed by the House and Senate, will not guarantee that we will be able to enact a second, more comprehensive banking bill in this Congress. It does, however, help create a climate that makes a second bill's passage more likely.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, in many ways this is the most important hearing the committee will have on the issue of restructuring the financial services industry. I am convinced that the Glass-Steagall Act has served our country well over the past 50 years.

Yet, times have changed. The banking industry is much different than it was in 1933. Indeed, so is our economy. Markets, particularly in financial services, have become internationalized. Advances in technology have caused dramatic changes in the provision of financial services.

Mr. Chairman, I believe that our investigation will prove that Glass-Steagall is still relevant in today's economy. However, that is not to say it can not be finetuned. I am looking forward to this morning's testimony. Thank you.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. I would like to commend the chairman for calling today's hearing. I would also like to thank our witnesses for the obvious time, care and extensive research efforts devoted to preparing testimony for this morning's hearing. I found their testimony to be extremely helpful in guiding our discussion of the Glass-Steagall Act.

I appreciate, Mr. Chairman, your efforts and those of the witnesses appearing before us today to look first at the history of the Glass-Steagall Act. Many have argued that the Glass-Steagall Act has served us very well for 50 years and that we should be extremely careful in changing such a long standing statute. Others argue that the act is an anachronism preventing our financial services industry from competing effectively in the increasingly internationalized capital markets. I am glad we have the opportunity to examine the basis for the Glass-Steagall Act and to look at whether the concerns of Carter Glass are still relevant in today's marketplace.

I look forward to this hearing because I believe that the question of whether banking and commerce or banking and securities activities can be safely and effectively combined is an important first step in a reexamination of our financial system as a whole. Such a reexamination is necessary so that we can dispense with the recent trend of "deregulation by loophole" and get on with the business of providing financial services in a safe, orderly and competitive fashion.

Thank you.

STATEMENT OF SENATOR JOHN HEINZ

Senator HEINZ. Mr. Chairman, I join you in welcoming our distinguished panels of witnesses who will discuss the origins of the Glass-Steagall Act and whether those underlying policy considerations are still relevant today.

More than 50 years ago, a wedge was driven into the market for corporate financial services in the United States—the Glass-Steagall Act. Since that time, commercial banks and their affiliates have been barred from underwriting and dealing in corporate securities and from certain other activities which have been the arena of the investment banking industry.

The orgins of this separation lie in the political and economic events of the 1920's and early 1930's. Needless to say, it has dominated the manner in which financial services have been supplied to corporations ever since.

Although the Glass-Steagall Act is probably the most well-known congressional pronouncement of the policy dictating the separation of banking and commerce, it was, by no means the first. In fact, since enacting the National Bank Act of 1864, Congress repeatedly has reaffirmed its determination that the public policy of the United States must be to separate commercial banking from unrelated areas of economic or commercial activity. The history of Federal bank regulation—as reflected in the enactment of the Glass-Steagall Act, the Bank Holding Company Act of 1956 and the Bank Holding Company Act Amendments of 1970—largely has been an effort to restrain the domination of commercial banks over nonbanking sectors of the country.

I recognize that the statutory and regulatory environment of the Nation's banking system prior to the enactment of the Glass-Steagall Act, was a far cry from what exists today. Prior to 1913, there were no major laws to protect the banking system. There was no Federal deposit insurance. There was no Federal Reserve. There was no expanded branch banking. There was no investor protection in the capital markets. A series of banking crises, culminating in the panic of 1907 produced the Federal Reserve Act. In the ensuing 20-year period, however, the system revealed its vulnerability to the abuses which continued to plague it.

As we're all aware, disaster—the great crash in 1929—served as an engine of change. The stock market crash and subsequent events gave rise to five major pieces of securities legislation. The collapse of the banking system in March 1933 produced a similar legislative response—the National Bank Act. This act provided for Federal deposit insurance, strengthened the Federal Reserve System, and expanded branch banking. More importantly, in response to the considerable, documented number of abuses that had occurred between large banks and their securities affiliates and customers in the pre-1929 period, it mandated an almost total separation of commercial and investment banking.

Congress reacted appropriately to the situation in 1933. The question that must be resolved through these hearings is whether that legislative response is still relevant to today's banking environment. Over the last 20 years, a combination of improved technology, high interest rates and easement of some regulatory constraints has accelerated the change in the role and character of banks. It has also blurred the distinction between banking and other financial activities. My concern which I have continually expressed during my tenure on the Banking Committee, is whether the removal of the statutory safeguards will resurrect the potential for recurrences of the abuses that gave rise to enactment of the Glass-Steagall Act in the first place. Conflicts of interest are inherent in the banking system. In the absence of Glass-Steagall, existing safeguards may not be enough to protect the system. Needless to say, the implications are enormous, both for the safety and soundness of the financial system, and the economy.

Mr. Chairman, I join you in welcoming our witnesses today and look forward to hearing their testimony.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. I appreciate the witnesses' efforts in providing the committee with their interpretations of the history of the Glass-Steagall Act. By examining the legislative history of that act as a starting point for our review of a need for comprehensive reform, I believe that we should first determine whether the concerns which led to the enactment of Glass-Steagall are still relevant today. A review of the relevant legislative history reveals that abuses the authors of the Glass-Steagall Act sought to remedy have actually been remedied. Further, the potential for the recurrence of the abusive practices eliminated by Glass-Steagall are very real unless we enact comprehensive banking reform that addresses the concerns originally raised during the hearings that led to the enactment of Glass-Steagall.

I believe that the Glass-Steagall Act has been a very positive influence on the stability of our financial markets. Further, I do not accept some of the "revisionist" interpretations of the legislative history of Glass-Steagall. Such revisionist interpretations are merely post hoc rationalizations by some in the commercial banking community who wish to destroy the barriers of Glass-Steagall for their own personal benefit at the expense of the safety and soundness of our financial markets.

Finally, I would like to reiterate several points I made at our last hearing on this subject. I believe that these should be the factors which should guide us on our quest for comprehensive reform of the regulation of our financial system.

First, if we are attempting to restructure the financial services industry, the Congress should take the lead. Deregulation by disaster as we have seen in the S&L industry and deregulation by the failure of certain regulatory agencies—such as the Comptroller—to implement and enforce the laws are not acceptable.

Second, a final determination that comprehensive reform of the financial services industry is needed to stave off foreign competition must be made by the Congress. To date, the evidence on this point is inconclusive. As Fed Chairman Volcker stated before this committee, American firms are on the cutting edge of foreign competition. Further, the growth of foreign markets has been precipitated by factors other than the inability of our domestic institutions to compete at home or abroad.

Third, reform of this industry must be truly comprehensive. We must not pay lip-service to the notion of comprehensive reform and continue to pass legislation creating built-in, Government created advantages that favor some institutions and not others.

Fourth, if comprehensive reform is needed, then we should at least procedurally look to the British example. The British model basically overhauled the entire financial system. We should not reform our system on a piecemeal, stop gap basis that is an exercise in loophole closing in the guise of comprehensive reform.

Finally, I think the Treasury plan outlined in a June 7, 1987, New York Times article should not be a model for comprehensive reform. That plan is a model for creating an oligarchical structure in the financial services industry and would severely impair the process of capital formation in this country. Further, it turns the procompetitive arguments for repealing certain provisions of the Glass-Steagall and Bank Holding Acts on their heads. The Treasury now argues that these provisions must be repealed to create an oligarchical structure which will be anti rather than procompetitive. Such large concentrations of wealth by a few institutions should be avoided rather than consciously created by so-called comprehensive reform.

I look forward to this morning's testimony.

STATEMENT OF SENATOR DAVID K. KARNES

Senator **Karnes**. Thank you, Mr. Chairman. I indeed look forward to the testimony today regarding the history and relevance of the Glass-Steagall Act. The relevance of the Glass-Steagall Act is undoubtedly the most controversial and hotly debated issue facing this committee in the area of expanded bank powers. Since passing the Glass-Steagall Act in 1933, Congress has not examined whether it has served any purpose that outweighs the public interest in promoting competition. A discussion of Glass-Steagall always generates the following questions which I hope we can address as we go forward; questions such as did the act play a major role in restoring the stability of the banking system? Would more competition benefit small and large companies that use investment banking services? Would allowing bank holding companies to own securities subsidiaries strengthen those companies and the system they are a part of? Can the potential conflicts of interest be regulated in the same way that similar potential conflicts are regulated now? Can we develop a system of proper disclosure, regulation, and judicial remedies to control the conflict of interest question?

I hope we can address these questions and many more as we review the whole question of expanded bank powers. I look forward to the testimony of the experts this morning and thank you for agreeing to participate in this historic review.

Senator RIEGLE. We will begin with Mr. Perkins and let me just say that we have the statements from several of you and will make those statements in full a part of the record, and I would ask you, if you can, to direct your comments as much as you can right to the heart of what you've come to speak about so we can get right into those issues.

STATEMENT OF EDWIN J. PERKINS, PROFESSOR OF HISTORY, UNIVERSITY OF SOUTHERN CALIFORNIA

Mr. PERKINS. Thank you.

A review of the history of the Banking Act of 1932 and the one provision divorcing commercial banking and investment banking and placing those two functions thereafter in separate financial institutions reveals that no singular causal explanation underlies the reasons for its enactment. Like most events in the past, this one had multiple causes, causes which commingled and interacted positively upon each other at a particular moment in time. I believe three factors deserve our attention however.

EVENTS THAT INFLUENCED THE BANKING ACT OF 1932

First, the influence of a few powerful personalities who were in the position to shape the text of the final legislation in committee.

Second, the influence of prevailing theories about what constituted sound banking principles.

Third, economic events as they unfolded in the late 1920's and early 1930's.

Starting with the first factor, every historian knows the danger of ascribing too much influence to the role of individual personalities in the historical process. Yet in certain circumstances they cannot be ignored, and this is one of those occasions. Any understanding of the origins of the separation of commercial and investment banking must take into account the role of Senator Carter Glass of Virginia, my home State incidentally, and other Congress persons who shared his general outlook.

Glass chaired the Senate committees which held investigations into the banking question over a series of years beginning in 1931. As a Member of the House years earlier, he had been instrumental in crafting legislation which created the Federal Reserve System and later he had served as Secretary of the Treasury under Woodrow Wilson.

Over the years, Glass had developed close working friendships with several academics who specialized in questions related to money and banking and whose views largely coincided with his own. Foremost in this category was Professor Parker Willis of Columbia University. Glass and Willis believed that the increasing institutional integration of financial markets in the 1920's highlighted by the encroachment by commercial banks through their security affiliates into the investment banking field was an unsettling and dangerous trend. Thus, they were predisposed to discover any justification for legal separation of the two financial functions if they could rally enough political support in the Congress to bring it about.

Their opinions in this regard were grounded in what many, if not most, financial experts of the day considered sound banking theory. That theory stressed safety over market efficiency. These developments occurred in an era before such safeguards as the FDIC and the SEC were in place to protect the general public. Bank runs and the loss of deposited funds were commonplace, especially in times of financial panic.

Thus, the soundness school put its highest priority on the protection of depositors. Theories centered around the so-called real bills doctrine—if bank assets were largely short-term loans, 90 days or less, made against the acquisition of current inventories, meaning tangible goods, then the possibility of sustaining losses was greatly minimized. Backed up by the Federal Reserve System which could provide instant liquidity by rediscounting the short-term paper, the commercial banking system could function safely and responsively.

The evolution of the British financial services market, where commercial and investment banking were traditionally separated, was frequently cited as the model to emulate and in this regard London exerted an overweening influence since it was generally recognized as the world's leading banking center in the first quarter of the century.

The involvement of commercial banks in investment banking seemed incompatible with the real bills doctrine. Through its underwriting activities, a commercial bank might end up with unsalable stocks or bonds and, therefore, a significant part of its asset portfolio might be comprised of illiquid securities, undermining the goal of insulating commercial banks from long-term financial commitments and threatening the moneys of depositors.

Although trust companies and later commercial banks had been involved in various forms of investment banking for decades prior to the 1930's, and they had found it a useful and profitable business venture, no significant alteration in banking theory arose to support this deviation from previous institutional behavior. Practicalities were the main line of defense. In the early 20th century a school of thought emphasizing the virtues of competition and market efficiencies within the financial services context, such as emerged in the 1960's and accelerated through the 1980's, was either not present or was far out on the periphery of academic respectability.

When events in the late 1920's appeared to confirm the worst fears of powerful decision makers about the dangers inherent in deviating from standard banking principles, then they sought the means through legislation to make certain that this institutional aberration would never be permitted to occur again. The complete divorce of commercial and investment banking may seem in retrospect to have been a heavy-handed method of dealing with depression era problems, but it did conform with prevailing wisdom about sound principles in the Anglo-American financial community.

Events which had an enormous impact were, of course, all connected to the Great Depression. Thousands of commercial banks failed. Few failures were actually attributable to their involvement in investment functions, but to persons suspicious about the dangers of more integrated financial markets, the depression and business failures intensified their negative attitudes about recent institutional trends.

The ongoing Pecora hearings in the early part of 1933 reinforced the outlook of men like Glass and Willis who already favored a total separation of functions. But, in my opinion, the Pecora investigation did not act to stampede formulators of banking legislation into including the divorce provision. Glass and his supporters believed that they were instituting a reform necessary for the long-run health of the financial services sectors and a reform intended to promote the soundness, meaning safety, of commercial banking. Although legislation creating the FDIC was also included in the 1933 act, Glass was highly dubious about its probable success. Therefore, divorce was the only certain path to protecting citizens who relied on commercial banks to preserve their monetary assets.

Curiously, Glass was among those who only 2 years later began to have second thoughts about the necessity of such a drastic and uncompromising step. The earliest versions of the Banking Act of 1935, which passed both Houses of Congress before going to the conference committee that Glass chaired on the Senate side, included provisions which would have permitted commercial banks to reenter the investment field as underwriters of corporate securities—as wholesalers but not as retailers.

Glass conferred with President Roosevelt in August 1935 and the President made absolutely clear his adamant opposition to any change in the existing law regarding the separation of the two banking functions. So Glass removed the offending section from the bill in deference to the President's wishes. In short, a majority in Congress were in favor of softening the divorce provision as early as 1935, but Presidential opposition thwarted their intentions.

What does a student of history bring to bear upon the more recent controversy over the course of deregulation of financial markets? I believe the key question centers on whether the repeal of the divorce provision in current law would lead to more competition in the investment banking field and the emergence of a less oligopolistic market structure. For that to happen, regional capital markets would need to be more fully developed in Chicago, Los Angeles, and Atlanta, plus to a more limited extent in maybe ten large cities across the Nation.

To achieve that outcome in an investment banking market, which has been traditionally oligopolistic for over 125 years and geographically centered in New York and Boston, it might be advisable to delay for a period of up to 5 years the involvement of all commercial banks presently headquartered in those two key cities. Applying an infant industries argument, commercial banks with strong regional name recognition might be given a modest head start toward the goal of creating a more geographically dispersed and less concentrated U.S. capital market. I see nothing wrong with that development and much to recommend it.

Thank you, Senator.

[The complete prepared statement of Edwin J. Perkins follows:]

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THE DIVORCE OF COMMERCIAL AND INVESTMENT BANKING: A HISTORY

by Edwin J. Perkins*

I

The Banking Act of 1933 was the last in the long series of reform legislation signed by President Franklin D. Roosevelt in the famous first one hundred days of the New Deal. However, neither of the two main features of the bill, the Federal Deposit Insurance Corporation guaranteeing bank deposits nor the section requiring all banking institutions to restrict their future business activities either to the field of commercial banking or, alternatively, to only investment banking functions, was really sponsored by the new administration. They were instead holdover programs initiated by Democratic legislators in prior Congresses. As finally constituted, the legislation for permanent reform of the banking structure almost drew a veto from the financially conservative new President,[1] chiefly because it included the controversial deposit guarantee experiment.

The success of the federal deposit insurance plan is at present widely acclaimed by economists, and it is the car-

dinal feature for which the entire act is now known.[2] In all the excitement over the F.D.I.C., however, the other major alteration, the divorcement of investment banking from commercial banking, has been almost totally neglected by both financial historians and economists. Arthur M. Schlesinger, Jr., in his massive *Age of Roosevelt*, misleadingly suggests that the divorce was simply the outgrowth of the sensational testimony in the Senate investigation of stock market practices during the spring of 1933, while Milton Friedman and Anna Jacobson Schwartz, in their definitive *A Monetary History of the United States 1867-1960*, dismiss the whole matter in one sentence.[3]

During the past decade the rapid expansion of commercial banks into new financial markets has renewed interest in the general question of bank diversification.[4] This is, therefore, a fortuitous time to review the history of relationships between commercial and investment banking and to

examine those forces which, by redefining existing arrangements, were instrumental in framing the fundamental outlook of current banking law. Using a broad approach to the general question of banking change, we can begin to understand the rationale of financial legislation in the depression period and, in particular, how events and preconceptions interacted to influence the behavior of those principles directly engaged in the debate over the separation of investment banking and commercial banking.[5]

For the most part, American students of financial policy in the late nineteenth century viewed the British experience as the general model on which sound banking practice should be based.[6] No doubt this was partly due to the sharing of a common language and culture, but, in addition, the preeminence of London as the world financial center and the success of the English banking system had great influence. The structure of the English financial system by the middle of the nineteenth century had evolved in a manner that made a sharp division between the types of institutions participating in the commercial banking and investment banking functions. Recognized banking authorities there considered investment banking an inherently risky and speculative venture and, for that reason, considered any dealings in stocks and bonds an improper business pursuit for financial institutions entrusted with the savings of the general public. To a greater extent than we are apt to realize, what in the United States is generally meant by conservative, or sound, banking practice is simply the tacit acceptance of English standards.

But on the European continent, the German financial system was developing in a much more unified organiza-

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[1] Raymond Moley, THE FIRST NEW DEAL (New York, 1966), 320. *Also see* Howard H. Preston, *The Banking Act of 1933*, AMERICAN ECONOMIC REVIEW, Vol. # 23 (December, 1933), at 598.

[2] Milton Friedman and Anna Jacobson Schwartz, A MONETARY HISTORY OF THE UNITED STATES 1867-1960 (Princeton, 1963), at 434. The authors believe federal deposit insurance to be the most important structural change to result from the panic and, in fact, "the structural change most conducive to monetary stability since state note issues were taxed out of existence immediately after the Civil War."

[3] Friedman and Schwartz, *op. cit.*, at 442 and Arthur M. Schlesinger, Jr., THE AGE OF ROOSEVELT: THE COMING OF THE NEW DEAL (Boston, 1958), at 434-445. Since this manuscript was completed, Vincent P. Carosso has made two important contributions to the literature. INVESTMENT BANKING IN AMERICA (Cambridge, 1970) provides a fine overview of developments within the investment banking field, especially in the twentieth century. His article, *Washington and Wall Street: the New Deal and Investment Bankers, 1933-1940*, BUSINESS HISTORY REVIEW 425 (1970), describes in detail the impact of new legislation on the financial community after 1934.

[4] This expansion has culminated in the development of a system of one-bank holding companies. Current law exempts any holding company that owns stock in just one commercial bank from many of the restrictions on diversification that would normally apply to any corporate entity with multiple bank holdings. Through this loophole in banking law, many large banks have expanded into related financial areas such as insurance and leasing. The possibility that large commercial banks may soon become part of the overall conglomerate system has caused much concern among government regulatory agencies. In addition, a number of commercial banks have requested permission to establish and then sell their own mutual funds to the general public. However, to my knowledge, that request has not as yet been granted, and no one-bank holding company currently owns any part of a firm directly involved in investment banking.

[5] In all modern capitalist systems there has been close cooperation between commercial bankers and investment bankers in the issuance of new securities. Even the most independent investment banking houses often find it necessary to borrow from commercial banks to finance temporary acquisitions of stocks and bonds. From this standpoint, there is no such thing as an absolute separation of the two banking functions.

[6] George W. Edwards, THE EVOLUTION OF FINANCE CAPITALISM (London & New York, 1938), at 166.

tional framework, and it was common practice for one institution to provide both commercial and investment banking services. I am convinced that the trend of change in American banking structure over the fifty years prior to the Great Depression—more in the direction of the German experience and away from English theory—and its irreconcilability with the conventional wisdom go far in explaining the constant clashes between the leadership of the financial community and the various forces of banking reform during a significant period of our history.

Most of the contributors to the construction of financial legislation in the United States had little understanding of the implications any given financial policy might have on our emerging industrial economy. Their notions of ethical behavior and sound financial practice were usually projections of the knowledge gained in managing their own personal affairs. Although a few members of the academic community who served as technical advisors to legislative committees had an extremely detailed knowledge of the mechanics of the modern financial system, their understanding of general macroeconomic forces was decidedly fuzzy. Efforts were made to fit the English standards to a uniquely American structure. In addition, the formulation of banking legislation was handicapped by the nature of the dual banking system, with state and national chartering agencies in competition to offer more "attractive," meaning lenient, provisions.

II

Early Institutional Development

As the banking system developed in the period after the Civil War, American financial practice generally conformed with the basic theory that the two distinct functions, commercial banking and investment banking, should be performed in separate institutions. This was regarded as the normal and proper behavior for banking institutions. However, the postbellum period also provided the atmosphere for the innovations introduced by a new type of financial institution, the trust company. Virtually unknown before 1860,[7] trust companies were destined to have a great influence on the structure of American banking.

Trust companies were organized under general state incorporation laws that in effect allowed the new enterprise to pursue any type of business activity.[8] At first, these institutions tended to specialize in the administration of estates and wills. But they eventually expanded customer services and began to solicit deposits from the public in competition with the traditional commercial banks. Customers were attracted to an enterprise offering a wide range of financial services as was revealed in a 1909 study:

> "It is a distinct convenience to most people to have all of their financial business attended to under one roof. The trust company will not only care for their banking business, but will also receive their valuables for safekeeping, care for their property, manage their estates temporarily or permanently, make investments for them, give financial and legal advice, aid in preparation of wills. . . ."[9]

Many trust companies, while assisting their business clients with overall financial planning, soon became involved in the preparation and distribution of corporate security issues.[10] In some instances the trust company acted only as a rather passive selling agent for the issuing company; in others, they gave the securities their stamp of approval and actively promoted them with potential investors. On occasion they purchased the securities themselves, either for individual trust accounts or for the bank's own portfolio of investments. Textbook writers in the financial field were quick to point out the conflict of interest which might erupt between promoting the securities of a favored business client and, at the same time, giving supposedly disinterested investment advice to individual customers. In these cases, however, the honesty and integrity of the banker was relied upon to prevent any "unsatisfactory" abuses.[11]

By the turn of the century, trust companies were known as organizations familiar with the interrelationships of all financial markets. They could, therefore, give more all encompassing, balanced advice to their various customers; in addition, the "department store" style of banking attracted new business.[12] An early chronicler of the trust company in its formative stages remarked that it seemed to "travel ahead of statute law." In his opinion, laws like the National Banking Act were meant to apply strictly to "established businesses," not innovative firms, and it would be unfortunate if new demands for regulation prevented a natural development so "in harmony with the changing conditions of American life." [13] Before the end of the nineteenth century, the freedom of general incorporation laws and the absence of any federal regulation facilitated the movement of trust companies into the fields of both commercial and investment banking.

Banks chartered by the individual states responded to the trust company challenge by demanding competitive powers from their legislatures. State banks had been virtually taxed out of existence in 1863 by the 10 per cent levy on their note issues but had reemerged in the 1870's as a result of the profitability of strictly deposit banking.[14] Their demands for broader charter privileges were generally met, so that by 1900 the distinction between trust companies and state banks was very slight in respect to their opportunities for diversified customer services, although the precise legal distinction was not the same in any two states.[15] These state chartered institutions were subject to far less governmental supervision and fewer restrictions than those banks chartered under the provisions of the National Banking Act, and the growth of the national banking system failed to keep pace with the rise of competitive institutions.[16]

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[7] A few trust companies were operating in the New England area prior to the war.

[8] George E. Barnett, STATE BANKS AND TRUST COMPANIES SINCE THE PASSAGE OF THE NATIONAL BANKING ACT (Washington, 1911), at 12.

[9] Clay Herrick, TRUST COMPANIES: THEIR ORGANIZATION, GROWTH, AND MANAGEMENT (New York, 1909), at 32.

[10] Fritz Redlich, THE MOLDING OF AMERICAN BANKING: MEN AND IDEAS (2nd ed., New York, 1968), at 394.

[11] James G. Smith, THE DEVELOPMENT OF TRUST COMPANIES IN THE UNITED STATES (New York, 1928), at 150.

[12] Harold G. Moulton, FINANCIAL ORGANIZATION AND THE ECONOMIC SYSTEM (New York, 1938), at 337. This term "department store" seems out of place in a financial history, but it was frequently used by writers in the 1920's to describe the diversified banks. The modern slogan is a "full service" bank.

[13] Herrick, *op cit.*, at 53.

[14] The 10% tax on state notes made it unprofitable to issue them. Some state banks were forced to liquidate, but many simply applied for and received

Initially, some nationally chartered banks had tried to prevent their competitors from gaining such broad corporate privileges. However, when they found it impossible to obtain preventive legislation, many made plans to enter the investment banking field themselves.[17] Many years prior to 1908, the First National Bank of New York had already entered the investment banking market. In that year, in response to the federal government's criticism of the bank's buying and selling of common stock, the First National Bank created one of the first security affiliates of a nationally chartered bank. The First Security Company was incorporated under New York state law and, therefore, was free to conduct investment banking, or any other business, on an unrestricted basis.[18]

Eventually, a long line of affiliate corporations sprang up as subsidiaries of national banks, especially in the urban areas. Through this legal device, national banks ultimately managed to achieve a competitive position in the investment banking field. Private bankers, who had heretofore concentrated mostly on their investment banking functions, began to accept deposits and became greater participants in the commercial banking field. In short, by 1914 there were no effective market barriers in law or custom to prevent financial institutions from diversifying into new areas of customer service. Banking practice was beginning to diverge from the predominate banking theory. The Pujo Committee, in its investigation of the existence of a "money trust," took notice of the growth of the affiliate phenomenon and reported unfavorably:

> "The national banks in the great cities are exceeding their charter powers in the character of the business they are conducting and from which their principal revenues are derived. They are acting as promoters, underwriters, and houses of issue for the securities of railroad and industrial corporations." [19]

Nonetheless, since the number of investors before World War I was still a small minority of the population and national bank affiliates were involved in only a small percentage of the total volume of new security issues, the affiliate problem did not cause much of a stir at this time. The subject was not even mentioned in the final draft of the Federal Reserve Act. Commercial banks were generally confining their promotional activities to local markets; a security issue of over ten million dollars was still considered large.[20]

III

The Impact of World War I

The events during and after World War I brought further institutional diversification and greater unification of financial services. The sale of government bonds to finance the war on a massive scale, unduplicated since the days of Jay Cooke's Civil War campaigns, caused a revolution in the ownership pattern of securities and in their method of distribution. Financial institutions were expected to assist the government in widely distributing the large war loans. They were encouraged to lend investors the purchase price of government bonds on liberal repayment terms. By the end of the war, every large urban bank throughout the country was involved in the creation of an atmosphere favorable to security investment that ultimately reached over 14 million Americans. Many banks and trust companies either expanded their bond departments or formed security affiliates to handle this new business.[21]

The security affiliate system received official recognition and tacit acceptance by the federal government during the war years. In an effort to strengthen the still experimental Federal Reserve System, state banks and trust companies were allowed to enter the new system without having to give up any of the corporate privileges granted to them by state law. The result of this decision by the Federal Reserve Board in Washington was to recognize formally the right of at least one class of member banks to engage in investment banking. Any national bank that had heretofore pondered the ultimate legality of the security affiliate system interpreted this move as a go-ahead signal to pursue profits in the investment banking field.[22]

Thereafter, the banking community through its profes-

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national charters. Later, bankers discovered that a profit could be made without the note issuing privilege; this in itself was a significant innovation.

[15] Barnett, *op. cit.*, at 1[illegible]

[16] *Ibid.*, at 201.

[17] Moulton, *op. cit.*, at 338.

[18] William N. Peach, THE SECURITY AFFILIATES OF NATIONAL BANKS (Baltimore, 1941) at 61. Affiliates were essentially subsidiaries of the parent bank. National banks formed these organizations to operate in many financial areas but I am primarily concerned with those dealing in the securities markets. Three common ways to form affiliates were—1) the stockholders of the bank were given a pro rata interest in the stock of the affiliate, 2) the affiliate was carried as an investment of the bank, and 3) the security affiliate was owned by a holding company which controlled the parent bank. This last method is comparable with the modern one-bank holding company.

[19] PUJO REPORT, MONEY TRUST INVESTIGATION, 62nd Cong., 3rd sess., H. Rep. 1593 (Washington, 1913), I, at 151.

[20] Judge Harold Medina, United States v. Morgan, 118 F.Supp. 621 (S.D. N.Y. 1953). The decision in this case was written by a judge who had made an exhaustive study of the history of the investment banking field and, in particular, of the seventeen large firms implicated in the government's antitrust suit. The decision is lengthy, generally devoid of legal technicalities, and extremely informative. The seriousness of the charge against these important firms no doubt served as a level for the judge to obtain a vast amount of information about an industry where secrecy is particularly prevalent.

[21] Raymond W. Goldschmidt, THE CHANGING STRUCTURE OF AMERICAN BANKING (London, 1933), at 132.

[22] Charles S. Tippetts, STATE BANKS AND THE FEDERAL RESERVE SYSTEM (New York, 1929), at 109-112.

sional organizations, the American Bankers Association and the Investment Bankers Association of America, was mainly preoccupied with the threat of restraints on laissez faire in the securities field by state legislatures, especially in rural areas. Since, after 1920, the national government was in the hands of friendly Republican administrations, there was no corresponding fear about the possibilities of burdensome constraints on the federal level. The annual proceedings of the ABA and IBAA during the 1920's were devoted mostly to efforts to achieve a uniform, unrestrictive system of state law.[23]

By 1922 there were 62 commercial banks directly engaged in investment banking and 10 others had formed security affiliates for that purpose.[24] Throughout the decade, some of the leading banks in the financial centers built up extensive branch systems across the nation for their security affiliates. In New York this movement was headed by the First National Bank, Chase National Bank, National City Bank, and the Guaranty Trust Co.; in Boston the leaders were the Old Colony Trust Co. and the First National Bank. The creation of an investment banking structure with many retail outlets was a sharp divergence from the traditional wholesale approach to security distribution followed by the older private banking houses like J. P. Morgan & Co. and Kuhn, Loeb & Co. A network of branch offices with a large force of security salesmen was established either through merger with local and national brokerage firms or by natural growth. Innovative leadership in the investment banking field was rapidly being assumed by the expanding commercial banking community. However, prior to 1927, participations by commercial banks in new corporate bond issues accounted for less than 20 per cent of the total volume and participations in preferred and common stock financings were negligible. In the early 1920's even the most aggressive commercial banks were reticent to become involved in the marketing of equity issues.

Besides a desire to make use of the valuable experience already gained by bank officers in their contact with security markets during the war period, two closely related economic developments affected commercial banks profoundly and added stimulus to the movement toward an integrated financial structure. After 1919, corporations of all types, not just railroads and heavy industries, discovered an American public, now committed to the investing habit, very receptive to new security issues of an unprecedented frequency and dollar volume. As a consequence of this new access to the supply of long-term capital, many companies found they were far less reliant on banks to provide short-term, seasonal financing. In addition, high profits gave many corporations such a large cash flow that outside borrowing was unnecessary. This decline in loan demand threatened the earning power of commercial banks and encouraged them to seek other opportunities for profit. An expansion of investment banking functions to offset the reduction in loan revenues was a course chosen by more and more large urban institutions.[25] In their announcements to bank stockholders of an intended diversification into full-fledged investment banking, bank officials generally stressed the opportunities for increased profitability, but invariably emphasized the conservative nature of all anticipated future operations.

The affiliate system of national banks received Congressional attention in the mid-twenties, but only as a peripheral issue. In 1924, Charles McFadden of Pennsylvania, Chairman of the House Committee on Banking and Currency, introduced an omnibus bill with the expressed intention of "saving the very existence" of the nationally chartered banking system.[26] This was to be done mainly by liberalizing the branch banking restrictions on national banks in order to make them more competitive with institutions organized under state law. In addition, there was a provision formally recognizing the security affiliates of national banks. The Comptroller of the Currency was to be given a minor role in regulating the activities of the affiliates.[27]

In an appearance before the Senate's Banking and Currency Committee in February of 1925, Representative McFadden explained the important features of his bill. Then he defended the section pertaining to investment banking:

> "It has been said that we are permitting national banks to engage in a new business without proper safeguards. . . . [N]ational banks have for many years been engaged in the business of buying and selling investment securities without any restrictions whatsoever. . . . They (security affiliates) are found in every national bank. . . . The authority is from Section 5136 (Federal Reserve Act) . . . empowering national banks to negotiate 'other evidences of debt'. . . . . Modern banking requires the conduct of an investment securities business." [28]

This position was challenged by Senator Glass, a committee member and one of the Senate's most respected authorities on banking legislation. He charged that the whole McFadden bill had been hastily prepared and suggested that no changes be made in existing law until a thorough review of

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[23] PROCEEDINGS OF ANNUAL CONVENTIONS, 1912-1934, American Bankers Association and Investment Bankers Association of America.

[24] Peach, *op cit.*, at 83.

[25] *Ibid.*, at 24.

[26] National banks were prohibited from establishing any branch offices in the 1863 National Banking Act. This put them at a considerable disadvantage in those states where locally chartered institutions were allowed broader privileges. However, these restrictions were not applied to the national banks' affiliates. The security affiliates of some of the larger banks had offices throughout the country and even in foreign countries. There were those who did not object to a bank's involvement in the security markets but argued that the affiliates were evading the branch banking laws.

[27] The Comptroller was given the duty of determining what types of securities were eligible for bank affiliates to underwrite. At first, he restricted the list to debt issues, but later he expanded it to include equity issues.

[28] HEARINGS ON THE CONSOLIDATION OF NATIONAL BANKING ASSOCIATIONS, Subcommittee of the Senate Banking and Currency Committee, S. 1782, 69th Congress, 1st session (1926), at 22.

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the complete banking system, presumably under his own direction, could be undertaken. Furthermore, in regard to the proposed authorization of the security affiliate system, he declared:

> "There is nothing in the national banking act that permits it. We have again the infrequent occurrence of being asked to legalize something that has been done without authority of law." [29]

However, at this time commercial banks were still only minor participants in the investment banking field despite the fact that their market share was rising. Glass's protests were, therefore, relatively mild. In an alternative draft of the entire bill submitted to the committee by Glass and his trusted friend, Professor H. Parker Willis of Columbia University, there were no changes made in the original wording of the section dealing with security affiliates.[30] In fact, few of the numerous witnesses before the committee even mentioned the issue of securities operations by commercial banks. That section of the bill was generally agreed to be one of the least significant and not worthy of much comment.

However, the passage of the McFadden Act in 1927, coupled with the sharply rising stock market prices from 1927 to 1929, encouraged an acceleration in the trend toward "department store" banking. Commercial banks became increasingly more active in the securities markets; their market share of new bond issue participations was boosted from 37 per cent in 1927 to 61 per cent in 1930.[31] (See Appendix I, page 527.) By the end of the decade commercial banks and their affiliates had become the dominant force in the investment banking field. The volume of security issues was so great in 1928 and 1929,

however, that even smaller firms were increasing their business on an absolute basis. Mergers between bank affiliates and competitors in the investment banking field increased rapidly. Overall financial power was being progressively concentrated in unified institutions. The Investment Bankers Association of America, which has elected its presidents from the ranks of the smaller institutions since 1917, was headed from 1931 through 1933 by representatives of the security affiliates of the larger commercial banks.[32] In practice the institutional separation of banking functions was, by the end of the 1920's, a thing of the past.

Financial journalists were divided in their reactions to these new developments. An article in the *American Bankers Association Journal* in June 1930, eight months after the stock market crash, extolled the virtues of the affiliate system and contended that the standards of investment banking had been uplifted.[33] However, the first issue of a newly organized magazine, *Fortune*, published in February 1930, was more skeptical about the interrelationships of commercial and investment banking. While recognizing the great profit potential for commercial banks in the underwriting field, the *Fortune* article went on to question "whether the cooperation may sometimes be too close, thus getting the bank into promotional difficulties of which it should be judge rather than advocate." [34]

A most significant event that incited public opinion against the security affiliate system was the failure of the Bank of the United States in December 1930. The president of the New York bank, Bernard Marcus, had appropriated vast quantities of the bank's funds for his own personal, and highly speculative, business ventures. The even-

tual financial difficulties of these outside investments made it impossible for Marcus to repay his loans. The bank was finally forced to suspend payment and to close its doors. When it failed, the bank had over $200 million in deposits, many of them owned by immigrants who erroneously believed the bank's name indicated a close connection with the national government. Rather than form various dummy corporations legally unconnected with the bank itself to handle his personal affairs, Marcus had for some reason chosen to establish bank affiliates for his illicit promotions. Because this was the largest bank failure in American financial history, the story gained extensive national exposure. The press attributed the failure mostly to the abuses of the affiliate system. Thereafter, the public and many politicians became very suspicious of the activities of all commercial bank affiliates.[35] This episode brought a new awareness of the extent to which the affiliate system had contributed to the institutional unification of the commercial and investment banking functions.

Thus, when the continued existence of the entire affiliate system was threatened, the close relationship between the two banking functions that had grown up within that system automatically became vulnerable. What first put the supporters of a unified banking structure on the defensive, then, was not a frontal attack on the theoretical incompatibilities of the commercial banking-investment banking association per se; it was, rather, an indirect assault aimed at the propriety of the legal entities, the affiliate subsidiaries, through which the unified structure had evolved. As the depression deepened, the critics of the affiliate system grew more vocal.

IV

Glass and His Ideas

After events had demonstrated that the depression

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[29] *Ibid.*, Senate Banking and Currency Committee, S. 3316, 68th Congress, 2nd sess., (1925), at 111.

[30] HEARINGS, S. 1782 (1926), at 160.

[31] Peach, *op cit.*, at 110.

[32] PROCEEDINGS OF ANNUAL CONVENTIONS, 1917-1933, Investment Bankers Association of America.

[33] H. H. Preston and A. R. Finlay, *Era Favors Investment Banking*, AMERICAN BANKERS ASSOCIATION JOURNAL (June, 1930), at 1153.

[34] *Banking, Group and Branch*, FORTUNE (February, 1930), at 138

[35] Bernard Bellush, FRANKLIN D. ROOSEVELT AS GOVERNOR OF NEW YORK (New York, 1955), at 115-123.

would find no sudden solution and as bank failures and scandals grew more numerous, Congress turned to that veteran financial legislator, Senator Carter Glass, to lead an investigation aimed at the permanent reform of the banking system. In 1912, Glass had served on the House committee that wrote a draft of the bill for a federal reserve system which rejected the central bank plan advocated by New York bankers and the American Bankers Association. The final working of the Federal Reserve Act of 1913 reflected in the main the views of Glass and H. Parker Willis, the committee's expert advisor on economic matters. Glass had subsequently served as Secretary of the Treasury for two years during the Wilson administration before accepting an appointment to the Senate in 1920. During his tenure as Secretary, he had maintained amiable relations with the financial community, and Russell Leffingwell, who took a leave of absence from J. P. Morgan & Co. to serve the government during the war years, had been one of his chief assistants.[36]

Glass considered the establishment of the Federal Reserve System the crowning achievement of his political career.[37] He and the other sponsors of the 1913 act idealistically believed that they were erecting a firm financial structure which would prevent liquidity panics and reduce the likelihood as well as the severity of depressions. The inability of the system to bring the country out of its difficulties following the 1929 debacle was, therefore, a bitter blow to the proud architect of the existent banking structure. Convinced beyond doubt that the Federal Reserve System had been perfectly created, Glass began a search to discover those factors which had crippled the law and were responsible for its current ineffectiveness.

The attack was launched in two directions. First, Glass tried to prod the Federal Reserve Board into pursuing more aggressive policies on the monetary front. The Board, he claimed, had ample powers to deal with the situation, if only it would act decisively. Then, he began to look for any "evil practices" that might have crept into the financial structure and contaminated it. It seemed clear to him that part of the trouble was caused by speculators and "stock gamblers" who, he felt, had wrested control of commercial banking away from the "legitimate needs of business" and diverted the people's deposits into unwarranted areas.

In two letters to the editors of *The New York Times* and *The Journal of Commerce* in 1928 and early 1929, Glass had warned of the dangers in the current economic situation. In the 1928 letter, he stated that the rapid rise of brokers' loans was proof the Federal Reserve System had failed in its efforts to guard against excessive speculation. But he held out the hope that things could still be corrected administratively without resort to the dangerous expedient of statutory readjustments, if the Board would act courageously.[38] By 1929 he was becoming more alarmed. Anyone who would defend "stock gambling" as productive and a wholesome thing for the human race as, for example "the growing of crops," he wrote, was guilty of "intellectual astigmatism." In addition, he made it clear that:

> "As a purely business proposition I would like to see excessive marginal speculation abated; but I have never bothered two seconds about the 'wickedness' of stock gambling. My concern has been for the economic integrity of the Federal Reserve banking system." [39]

During his preliminary investigation in 1930, Glass was especially on the lookout for any new practices of commercial banks that were not explicitly authorized by the original Federal Reserve Act and also for any "unsound" involvement the banks might have had with the security markets. The affiliates, of course, were vulnerable on both counts. There was no doubt in his mind that a major cause of the depression had been the distortions which had made the Federal Reserve System a servant to the needs of investment banking.

In fact, from just a common-sense, cause-and-effect standpoint, one could easily make a formidable argument against the security affiliate system. No sooner had the McFadden Act taken effect, than the great bull market had gotten under way! During the period from 1928 through 1930, commercial banks had substantially increased their market share of the new bond issues and had begun to make inroads in the equities market. No matter what significance one might give that development today, certainly to the national legislators of the early 1930's the probable correlation must have made a strong impression. This was particularly true of a financial "purist" like Carter Glass.

However, Glass had no illusory dreams that his proposed reforms would cure the depression. On the contrary, he assigned that role to the Federal Reserve Board and castigated it for its do-nothing attitude. His reforms were designed for the long run health of the financial community and the country as a whole. They were not meant to repair the current breakdown, but to prevent a similar catastrophe sometime in the future. He was remarkably free from any anti-business bias and throughout the controversy over his bill maintained his close relationships with many respected Wall Street figures. Ninety per cent of all bankers, he often said, behaved in a sound manner; but, because of lax laws, the other ten per cent were prone to submit to their baser tendencies and, as a consequence, gave everyone a bad name."[40] Yet, he was optimistic that, if he could only persuade special interests to take a broader outlook, he could revitalize the Federal Reserve System and create a truly national banking structure impervious to "speculative wrecking" in the future.

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[36] *See* Rixey Smith and Norman Beasley, CARTER GLASS (New York, 1939) and James E. Palmer, CARTER GLASS, UNRECONSTRUCTED REBEL (Roanoke, Virginia, 1938).

[37] *See* Carter Glass, ADVENTURES IN CONSTRUCTIVE FINANCE (Garden City, 1927).

[38] Carter Glass, *Letters to the Editor*, THE JOURNAL OF COMMERCE, June 7, 1928.

[39] *Ibid.*, NEW YORK TIMES, August 21, 1929.

To assist him in the preparation of new legislation, Glass invited back to Washington Professor H. Parker Willis, whose views on financial matters closely paralleled his own. Willis was generally recognized as the leading expert on banking in the country.[41] Professor Willis was on the faculty of Columbia University where a host of academicians were actively analyzing banking questions.

Banking experts believed that the financial system was subject to "scientific" analysis. This analysis, as proven in England, demonstrated that if banks limited their lending activities to loans for bona fide commercial purposes, the entire economic system would automatically adjust to the "needs of trade." Depressions, when unavoidable, could at least be prevented from causing chaos and panic in commercial banks. Beyond the establishment of a sound system of finance, nothing much could be done to promote economic stability except to educate bankers to use good judgment and to increase bank examinations by outside auditors. In their outlook there was an aura of fatalism. The logical source of funds for permanent capital investment in the economy was from the "real savings" of the populus, not bank deposits. The orthodoxy of this so-called "real bills doctrine" or "commercial loan theory of banking" has strongly affected our monetary policy throughout our history.[42] H. Parker Willis was not only under the influence of

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[40] HEARINGS ON THE OPERATION OF THE NATIONAL AND FEDERAL RESERVE BANKING SYSTEMS, Subcommittee of the Senate Banking and Currency Committee, S. Res. 71, 71st Congress, 3rd sess. (1931), Part I, at 281.

[41] Joseph Dorfman, THE ECONOMIC MIND IN AMERICAN CIVILIZATION 1918-1933 (New York, 1959), at 314.

[42] Lloyd W. Mints, A HISTORY OF BANKING THEORY IN GREAT BRITAIN AND THE UNITED STATES (Chicago, 1956), at 1-10.

orthodox theory, he was one of its chief proponents.

In a textbook on investment banking published in the summer of 1929, Willis objectively pointed out the increasing penetration of the securities markets by commercial bank affiliates; but he gave no indication that there was anything objectionable about the trend. At one point, he even suggested that speculation was commendable if it encouraged people to save and broke them into the "security-buying habit."[43] Thus, we find an avowed advocate of the virtues of English functional separation for over thirty years lulled by the possibilities of a "New Era" of economic growth. Willis had modified his textbook principles in the light of the latest innovations in banking practice.

Then the 1929 stock market crash shook Willis and his associates out of their complacency. It reaffirmed an old belief that short-term deviations from standard truths eventually brought drastic economic consequences. While Willis had throughout the 1920's warned the banking community of the dangers of excessive speculation, I feel certain he felt a sense of regret because he had not been vigilant enough in guarding the banking system from what in retrospect were to him clearly unsound policies. During the hearings on the McFadden Act, he himself had called the growth of the security affiliate system inevitable since it corresponded with the movement toward expanded services in other parts of the American economy.[44]

One of the tenets of Progressive thought had been a simplistic attitude toward the financial community which assumed that a smoothly functioning economy was "controlled" by a "money trust"; an economic breakdown, on the other hand, resulted from the "corruptions" of that same "money trust." The Pujo Committee investigations of 1912 were partially responsible for this outlook. The postmortems on 1929, therefore, concentrated on the corruption rather than the control issue. In fact, the fear over the lack of competition in the investment banking field, a favorite complaint of the followers of Louis Brandeis who were anxious to give the "little man" access to the capital markets,[45] was replaced by a new concern about the dangers of "overcompetition" which had supposedly contributed to the speculative mania. The security affiliate, because it was in the forefront of the retailing approach to security distribution, was now being cited as the chief stimulant to "excessive competition." Suddenly, Willis realized that the opposite of banking "control"—the easy access of corporations to the general public through the securities markets—had its hazards too.

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[43] H. Parker Willis and Jules I. Bogen, INVESTMENT BANKING (New York and London, 1929), at 267.

[44] Dorfman, *op cit.*, at 318.

The credit standards applied to business loans by banks with security affiliates, Willis believed, showed a tendency to become lax. A bad loan or a frozen loan could be quickly liquidated by a public offering, so there was no longer any necessity for undue precaution in the extension of bank credit. Ironically, commercial banks were contributing to the declining importance of their traditional lending power through the operations of their affiliates. What needed to be done now was to give back to the commercial banking sector of the economy some of its recently lost control over the flow of credit. Money trust control of business expansion was perhaps preferable to no control at all. Willis felt that new legislation restricting institutions to limited financial functions would go a long way toward reconstructing the more stable financial world of the pre-World War I days and make it difficult for a glut of "undigested" securities to flood the country.[46]

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[45] See Louis D. Brandeis, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT (New York, 1914).

[46] HEARINGS ON A RESOLUTION FAVORING A RESTRICTION OF LOANS BY FEDERAL RESERVE BANKS FOR SPECULATIVE PURPOSES, Senate Banking and Currency Committee, 70th Congress, 1st sess. (1928), at 23.

In formulating the section of the bill which dealt with the security affiliate problem, Glass and Willis were operating under a number of powerful restraints. First, there was the nature of the dual state and national banking system, and the certain resolute opposition by influential bankers to anything which might seem too radical. Legally, Congress could prescribe the rules for the operations of all nationally chartered banks and, in addition, regulate the membership requirements for state institutions participating in the Federal Reserve System. But there appeared to be no way to prevent every financial institution from acquiring state charter powers and then withdrawing from the Federal Reserve System. As much as Glass wanted meaningful reform, there was nothing he would do that might realistically jeopardize the strength of the Federal Reserve System.

A second problem was the reality of the political situation in 1930. The prospect for the passage of an omnibus banking bill with too many unpopular provisions would not be good in the still Republican controlled Senate. Glass himself wanted to stay away from anything too revolutionary. The Hoover administration could not be counted on to support any really comprehensive bill that incited a great deal of Wall Street opposition. President Hoover was hoping for "self-reform" in the financial world and no doubt felt the prospect of legislative meddling by a Congressional committee would prompt the financiers to clean up their own house. If one can discount his later claim, that he had been a spearhead in the drive for banking reform, still, it can be said, that Hoover did not try to prevent Glass from carrying on a thorough investigation.[47] By the same token, Glass never actively sought the administration's support. However, a careful review of the two men's outlook on financial matters would show them in virtual agreement on most issues, including I would venture a guess—the divorce of commercial and investment banking. However, not until after his defeat in 1932, did Hoover find the political courage to make his real convictions known. His sincere regret at not giving Glass more support led him in his memoirs to substitute a version of events that coincided with what he had wanted to do all along for events as they actually happened.

In the face of those difficulties, Glass and Willis included in their preliminary draft two sections related to the affiliate question. One section called simply for the examination and regulation of affiliate activities; commercial banks would still be permitted to continue their investment banking functions. In addition, private banking firms would be permitted to retain their deposit business so long as they made their entire operations open to federal or state inspection.[48] The other section went much further. It proposed to sever all connections between commercial banking and investment banking within five years from the date of passage, with thorough examination during the interim period. Their strategy was clear; the inclusion of the maximum goal —divorce—would act as an inducement to the banking community to acquiesce more willingly to a minimal alteration in the financial system—periodic examinations of all affiliates. In addition, economic and political developments might eventually make the realization of the maximum goal possible. They believed a separation of the two banking functions to be in the best interests of the overall banking structure; but in late 1930, when they began drawing up a bill, they felt such a plan would be deemed too revolutionary and would not have much chance of passing the Congress.

V

The Hearings—Ideas and Realities

Hearings on the Glass Banking Bill were held on two occasions; once before the Banking and Currency subcommittee chaired by Senator Glass in the winter of 1931 and then again one year later before the full committee. All interested parties were invited to appear in Washington to state their views. Appearances were made by spokesmen from the American Bankers Association, the Federal Reserve Board in Washington, the New York Federal Reserve Bank, some of the larger banks with security affiliates, and the Investment Bankers Association of America. Glass was a skilled debator, and he made maximum use of the hearings to theorize about the causes of the current depression and to defend stoutly his proposed reforms. The general problem, as Glass then saw it, was that the Federal Reserve System was no longer really operational:

> "Instead of creating a national standard of sound banking which the state systems might be induced to follow, we have introduced into the national banking system some, if not many, of the abuses of the state systems, in order to enable national banks to compete with state banks." [49]

There was no real debate in the committee rooms over the wisdom of extending bank examination procedures to include security affiliates. Some banks had even voluntarily invited outside agencies to examine the books of their affiliates as far back as the mid-twenties. On this issue there was no disagreement. However, there was considerable disagreement about the propriety of requiring a complete separation of commercial and investment banking.

Of the eight main witnesses who advocated a complete separation, four were members or former members of government regulatory agencies, two were Midwestern bankers, one was a well-known academician, and the other a top manager in a Wall Street commercial bank that had not ventured into investment banking. In general, this group argued that the unification of commercial and investment banking functions within one institution was an unhealthy financial trend, contrary to recognized principles of sound banking. They were particularly critical of the security affiliates of commercial banks. The activities of these affiliates, the witnesses charged, "artificially" stimulated the stock market, diverted resources away from their proper commercial channels, and, in addition, subjected a bank's depositors to improper risks. In the present institutional arrangement, even those depositors most adamantly against speculative investment could not be sure their funds were not being used by bank officials to market new issues. Such a deplorable situation needed corrective legislation.

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[47] Herbert Hoover, THE MEMOIRS OF HERBERT HOOVER (New York, 1952), Vol. 3, at 21-24.

[48] Parker Willis and John M. Chapman, THE BANKING SITUATION (New York, 1934), at 69.

[49] HEARINGS, Subcom. on S. Res. 71 (1931), Part I, at 14

One of the first witnesses to call for complete divorce was Adolf C. Miller, who had been a member of the Federal Reserve Board since 1914. As the only Board member with an academic background, he frequently dissented from the views of the Board majority. Some of the affiliates involved in investment banking he characterized as "little more than market operators." [50]

The Superintendent of Banking for New York, John Broderick, an appointee of Governor Franklin Roosevelt, came to the same conclusion from a different background. He had been invited to testify because his official duties had already involved him in the operations of many of the larger affiliate systems. He told the committee that as a result of his investigation into the failure of the Bank of the United States, he was recommending to the State Legislature a series of reform proposals "some of which my good banking friends consider quite radical." Among them was a provision "to provide that an officer of a banking institution shall not be permitted to become an officer of any company primarily engaged in the business of the purchase and sale of securities." The intent of the section was to put an end to the affiliate system, although nowhere in the document was that goal so bluntly stated. Superintendent Broderick did

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[50] *Ibid.*, at 148.

not indicate whether Governor Roosevelt had endorsed his proposals to separate commercial and investment banking in New York State.[51]

Other witnesses recommending a complete divorce of the two banking functions included Owen D. Young, Chairman of the Board of the General Electric Company and an influential member of the board of directors of the New York Federal Reserve Bank, George Davidson, President of Central Hanover Bank & Trust Company, and Professor William Z. Ripley, Harvard economist and author of an important book, *Main Street and Wall Street*, critical of stock market practices. The last termed the close association of securities companies with commercial banks "a great temptation—almost irresistable in weak hands" for investments to be diverted into areas that would cause undue risk to a bank's depositors.[52] Somewhat along that same general line, Senator Glass had earlier expressed his dissatisfaction with security affiliates that were "trading on the good name of the bank." Any decline in the price of securities recommended to an investor by an affiliate, he said, "casts disgrace on the bank." [53]

The most prestigious witness was Eugene Meyer, Governor of the Federal Reserve Board. He presented the committee with a formal letter that expressed the unanimous position of the Board on the entire Glass Bill. With a few reservations, the letter supported the passage of most of the bill's provisions. One pertinent paragraph read:

> "The Board realizes that many evils have developed through the operation of affiliates connected with member banks, particularly affiliates dealing in securities. The attached memorandum contains a draft of a provision for the separation of affiliates after a lapse of three years."

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[51] *Ibid.*, Broderick testimony, at 271-285.

[52] *Ibid.*, at 480.

[53] HEARINGS ON THE OPERATION OF THE NATIONAL AND FEDERAL RESERVE BANKING SYSTEMS, Senate Banking and Currency Committee, S. 4115, 72nd Congress, 1st sess. (1932), Part 1, at 34.

However, he later admitted that there had been lengthy discussion about the separation clause, and he asked the committee not to consider the Board's statement on the affiliate question as a firm recommendation, but as merely a suggestion.

During his testimony the following exchange occurred:

> Senator Glass: "We have had testimony here that if we eliminate just those affiliates that are doing that wretchedly bad business, it will result in a great deal of deflation."
>
> Governor Meyer: "Well, it is impossible to classify absolutely all affiliates that deal in securities as wicked and vicious."
>
> Senator Glass: ". . . There are some things that ought to be deflated. Stock gambling is one of them, and unloading on the portfolios of banks $12,000,000 as foreign investment loans and things of that sort ought to be deflated; and any time is opportune to deflate them in my judgment."
>
> Senator Couzons: "As a matter of fact, practically all these affiliates were developed by smart attorneys to evade the banking laws."
>
> Governor Meyer: "Yes . . . except that they were allowed to continue, and the Congress of the United States knew as well as anybody else that they were developed to evade the law."
>
> Senator Glass: "Now, when we want to put a stop to them, we are told the time is not opportune."
>
> Governor Meyer: "A practice that has grown up with the semblance of legality, even though primarily designed to evade a law, because the Congress and the authorities did not object to it, although they knew about it, gains a certain right to be treated with consideration."
>
> Senator Couzens: "It is one of those things that is allowed to go on when no trouble develops, and as soon as trouble develops, of course, everyone is wise."

As the exchange suggests, Governor Meyer had given at best a lukewarm endorsement to the divorce movement. He finally confessed that the whole question "is in the realm of the unknown to a certain extent, because of the absence of full information." [54]

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[54] *Ibid.*, Meyer testimony at 357-400.

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As the exchange further suggests, some of the committee members were even more enthusiastic for the divorce provisions than the witnesses who favored them. Senator James Couzens of Michigan demonstrated the kind of support Glass could count on from the more progressive factions in the Republican party. Prior to his election to the Senate, Couzens had been a partner of Henry Ford and was, therefore, somewhat of an insider within business circles himself. It was difficult for Wall Street interests to accuse a man with his business experience of a failure to appreciate the practicalities of day-to-day banking. Couzens was a sharp critic of the financial community, perhaps reflecting the general prejudices of most of our early automobile manufacturers, and a valuable ally in the crusade against the affiliate system.

Opponents of the divorce clause were no less articulate in their appearances before the committees. Most of the sixteen witnesses who urged the committee members to limit reform to an extention of the examination privilege were representatives of the urban banking community. The group included the presidents of leading banks directly threatened by the proposed constraint on diversification, some members of the board of directors of the New York Federal Reserve Bank, and the Comptroller of the Currency. They invariably argued that a forced separation of the two banking functions would be highly deflationary. With the economy already in an extremely depressed state, it was not the proper time to erect impediments to the future recovery of the securities markets. All of them, regardless of their opinions about the eventual need for reform, emphasized the ill timing for any radical change in the nation's financial structure.

One of the most forceful defenders of the status quo was the Governor of the New York Federal Reserve Bank, George Harrison, the successor of Benjamin Strong. He was a respected spokesman for the overall Wall Street community. He differed with the recommendations of the parent Federal Reserve Board and the views of one of his own board members, Owen Young. His testimony included the following exchange:

> Governor Harrison: ". . . [A]nd I think if we were considering a virgin field and wanted to devise a brand new banking system in the light of present experience I myself, would prefer that no commercial bank be permitted to have such an affiliate."
>
> The Chairman (Senator Glass): "Well, if it be an evil, why not correct it? Why let an evil persist simply because we did not correct it to begin with?"
>
> Governor Harrison: "After all, the lapse of time makes a difference if only because it teaches customers of banks the privileges and facilities they now get under this departmental system. If that is true and there is advantage in it, is there anyway in which you can accomplish the same purpose without completely divorcing them. . . ."

Then a little later:

> The Chairman: "Well, I myself, for the reason indicated by you rather question the feasibility maybe of abolishing them because they have been permitted for so long to exist. It might create a confusion and embarrassment that would be worse than the evil itself."
>
> Governor Harrison: "It might be a real disservice to the community, especially if it is possible to properly control them."
>
> The Chairman: "If it is not possible to control them in some way, I should be agreeable to prohibiting them."

Until regulation and examination had been tried and found ineffective, Harrison believed commercial and investment banking should be allowed to coexist in one institution.[55]

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[55] HEARINGS, Subcommittee on S. Res. 71 (1931), Part I, Harrison testimony, at 31-106.

President Albert Wiggen, representing the Chase National Bank and its security affiliate, the Chase Securities Company, told the committee of the extra business generated for the bank's other departments by the activities of affiliate organizations. In addition, he reminded the senators that their reach could not extend to those institutions chartered by the states and outside of the Federal Reserve System. There was a veiled threat that any legislation his organization deemed too restrictive would prompt a quick shift to nonmember status.[56]

More testimony favorable to a unified banking structure came from a former member of the Federal Reserve Board, Edmund Platt. After ten years of service in Washington, he had left the Board in 1930 to accept a Vice-President's position with the Marine Midland Bank in New York. Platt was very positive in his defense of the affiliate system and the overall trend toward a unified financial structure. "Affiliates are doing something like what the German banks do directly," he told the committee, "that business is not wrong. It is useful if properly done . . ." [57]

There was a lively session on the day Charles Mitchell, president of National City Bank and its security affiliate, the National City Company, came before the committee. He and Senator Glass had been at odds for years. Back in the spring of 1929, Mitchell had announced that his bank would continue to support the brokers' loan market irrespective of any deflationary action that the Federal Reserve Board might initiate. Glass had denounced him then, saying he had slapped the Board "squarely in the face," and had demanded his resignation from the board of directors of the New York Federal Reserve Bank. Later, in November 1929, Glass had charged that Mitchell was "more responsible than all the others put together for the excesses that have resulted in this disaster." [58]

Mitchell stated that his bank had had security affiliates for over twenty years, and that there was nothing at all illegal about their operations. In his opinion, these affiliates were not doing anything the bank could not also do in its own name. The affiliate system was originally formed for administrative purposes, Mitchell insisted, and not to evade the law.[59]

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[56] *Ibid.*, Wiggen testimony at 183-209.
[57] *Ibid.*, at 216.
[58] Peach, *op. cit.*, at 152.

A Boston banker, Colonel Allen M. Pope, agreed with Mitchell on the positive aspects of the security affiliate system in the American financial markets over the last ten years. Speaking for his own firm, First National-Old Colony Corporation, and the Investment Bankers Association of America of which he was the current president, Pope appeared before the committee on two occasions. He credited the expansion of the affiliate system and the new retail channels of security distribution with instrumental roles in making possible the rapid economic growth of the 1920's. Then he outlined in detail the evolutionary process through which the First National Bank of Boston had entered the investment banking field. There was nothing sinister about this entry into the securities markets, he assured the senators, but a gradual change in response to the demands of customers.[60]

Two of the most stinging criticisms of the Glass proposals came from bankers in Pennsylvania and Minnesota. Howard Wolfe, an officer of the Philadelphia National Bank, was a member of the Economic Policy Committee of the American Bankers Association and, in addition, served as the manager of the Philadelphia branch of the Reconstruction Finance Corporation. The whole Glass bill, Wolfe testified, was not appropriate for dealing with the real crisis in American banking—the hundreds of small banks across the country which were failing every year. "The only kind of bank this puts any further regulation or restraint on are

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[59] HEARINGS, Subcommittee on S. Res. 71 (1931), Part II, Mitchell testimony, at 285-322.

[60] *Ibid.*, Pope testimony, at 539-555 and *Hearings*, Committee on S. 4115 (1932), at 18-52.

the strong and big banks that have not gone down," he stated, "while the little banks that have gone down are not touched by this bill directly at all."[61]

In a subsequent appearance before the committee, L. E. Wakefield reached a similar conclusion about the inappropriateness of the Glass divorce reform, but for different reasons. Wakefield, the chief executive of the First National Bank of Minneapolis, Minnesota, was a strong advocate of government regulation in the investment banking field. Therefore, he felt that the elimination of investment banking functions in the commercial banking system would make the economy subject to less rather than more real control. "The committee would do a greater service to the country by retaining and regulating the security business through the power which Congress has over the national banks," he told Glass, "than by driving that business into less responsible hands over which Congress has no power of regulation."[62]

The hearings finally ended in March 1932. After weighing all the testimony pertinent to the divorce issue, the committee decided to incorporate the provision suggested by the Federal Reserve Board in the version of the bill reported out in April. That provision provided for a three-year phase-out period during which financial institutions could gradually leave either the investment banking field or the commercial banking field. On the face of it, this represented a tightening up of the divorce section, since Senator Glass's original proposal had called for a five-year lapse between final passage and the implementation of the divorce decree.[63] Nonetheless, while public opinion was growing in

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[61] HEARINGS, Committee on S. 4115 (1932), Part II, Wolfe testimony, at 263-278. An article in FORTUNE expressed a similar view; *op. cit.* (February, 1930).

[62] *Ibid.*, Wakefield testimony, at 339-353. For a similar point of view see Steven L. Osterweis, *Security Affiliates and Security Operations of Commercial Banks*, HARVARD BUSINESS REVIEW (October, 1932), at 124-132.

[63] SENATE REPORT No. 584, on S. 4412, 72nd Congress, 1st sess., April 22, 1932.

favor of separation, and many businessmen as well as strictly investment banking firms favored it, Glass still did not feel that he would be able to obtain such strong legislation at this time. In fact, Professor Willis in his 1934 book, *The Banking Situation*, suggested that after the close of the hearings Glass may have been amenable to a compromise on the divorce issue. In return for speedy action on the other, less controversial parts of his bill, Glass might have agreed to eliminate the divorce provision entirely and settled for extended government supervision and examination of security affiliates.[64]

VI

Changing Events Make Passage Easier

Meanwhile, in January 1932, Senator Glass had officially introduced his bill for permanent reform of the banking system. President Hoover responded by calling the Senator and asking his consent to a complete review of the bill to be carried out by a properly qualified group of administration appointed "experts." While he was sympathetic with some form of new legislation, the President indicated that he had been informed that the bill, as it then stood, contained dangerous and radical provisions. All of the so-called experts who made up the President's review board were friendly to Wall Street interests. Their report, as Glass had anticipated, was nothing less than an overall denunciation of the entire bill. Glass immediately countered with a forceful Senate speech in which he accused the bankers and their allies of stirring up public opinion against his bill in a manner reminiscent of the tactics used back in 1913 to fight

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[64] Willis states that Glass had dropped the divorce provision from the bill. However, a check of the entire series of bills introduced by Glass in the spring of 1932 fails to confirm Willis's statement. Since he was a confidant of Glass and his testimony is generally reliable on other matters, it is difficult to completely disregard his version of the bill's legislative history. It could be that Willis really meant to be describing Glass's intentions in the event he felt it would be necessary to compromise. Regrettably, there is nothing in their lengthy correspondence to confirm or deny this hypothesis.

Senator RIEGLE. Thank you very much.
Mr. Ritchie.

STATEMENT OF DONALD A. RITCHIE, ASSOCIATE HISTORIAN, SENATE HISTORICAL OFFICE

Mr. RITCHIE. Thank you, Senator.

I am very pleased to have this opportunity to discuss the historical origins of the Glass-Steagall Act. This is the act that President Roosevelt signed on the last day of the first 100 days of the New Deal, but the theme of my remarks is that this was not a New Deal legislation; that in fact it was a congressional piece of legislation, that its entire impetus came from Congress and that its conception came not from the New Deal but from the progressive era.

It also was fostered by a very dramatic series of hearings which the Senate Banking Committee held between 1932 and 1934. Following upon Mr. Perkins' remarks, while I would agree with him that the Pecora investigation had no impact at all on Senator Glass, who in fact was quite hostile to those investigations, that investigation did have a tremendous impact on public opinion, on the Congress and on President Roosevelt. And I think it did change the political atmosphere which allowed the Glass-Steagall Act to pass at a time when very few political commentators thought it had a chance.

ORIGINS OF GLASS-STEAGALL

Its origins do go back to the progressive era. You can find almost all the provisions in the act that were talked about during Woodrow Wilson's administration and even in the Taft administration. Senator Glass was the chairman of the House committee when the Federal Reserve Act was passed. He was very concerned that many of the banks in the country, thousands of them, were outside of the Federal Reserve System and that in fact even during the very prosperous 1920's over 5,000 banks in the United States failed, most of these being small, State, undercapitalized banks.

And he was working during this period to try to bring more banks under the Federal Reserve System. He was also very concerned from the beginning about the increasing involvement during the 1920's of commercial banks in the investment banking field and he called this for stock gambling purposes.

After the events of 1929, he suggested that these banks' involvement in the securities markets had been the largest contributor to the economic collapse.

Senator Glass was a staunch conservative, but his ideas were also mirrored in the more liberal wing of the progressive era, particularly in Louis Brandeis' very influential book "Other People's Money and How the Bankers Use It," which was published in 1914 before Justice Brandeis went on the Supreme Court.

And the third theme that went into this law was the idea of deposit insurance, which is right now the least controversial portion of the Glass-Steagall Act, and yet at that stage was probably the most controversial and most argued piece of the legislation.

It was proposed originally by Presidential candidate William Jennings Bryan. It was supported by Representative Steagall as early as 1923 in the House of Representatives.

The other progressive influence I want to suggest here was President Herbert Hoover who, while he doesn't have a progressive image, in fact did come out of the progressive movement and was a supporter of Theordore Roosevelt's Bull Moose Party, and worked for Woodrow Wilson. In fact his most recent biography of him was entitled "The Forgotten Progressive."

Hoover came into office very concerned about the condition of the Nation's securities markets and he acted to stop what he called the orgy of speculation, but he was frustrated at this time by the banks' refusal to go along with the Federal Reserve Board's attempts to try to slow down the amount of credit that was available for stock market speculation, particularly National City Bank, which he had some very negative things to say about in his memoirs.

When he ran for reelection in 1932, he suggested that the American people: "must be relieved from conditions which permit the credit machinery of the country to be made available without check for wholesale speculation in securities with ruinous consequences to millions of our citizens and to our national economy."

Well, after the stock market crash in 1929, another 5,000 banks failed over the next 4 years and in the same period Senator Glass was introducing a whole series of legislation in the Senate Banking Committee to try to address these problems. They began rather modestly.

The first bill in 1930 called only for the national banks to file regular reports annually on their securities affiliates, and later the provisions began to suggest dividing them completely. They were opposed on two ends—one by the American banking community which asked for less regulation rather than more regulation, and the other by the populist side in the Senate represented by Senator Huey Long, who felt that these favored the Northeastern banks and too centralized the banking system. Senator Long filibustered against Glass' act in 1932 and kept it from becoming law.

My own research has been in this committee's hearings in 1932 and 1933 and 1934 under the direction of Ferdinand Pecora, the committee's energetic chief counsel. These committee hearings had the advantage of bipartisanship. They were begun under a Republican President with a Republican chairman. They were concluded under a Democratic President with a Democratic chairman. In every way, the Pecora investigation is a model of a Senate investigation. They conducted extensive research. They uncovered startling facts. They fully publicized their evidence to educate both the Congress and the public. They facilitated the enactment of a whole series of major legislation, Glass-Steagall being the first, also the Federal Securities Act, the Securities and Exchange Commission Act, the Public Utilities Holding Company Act. And while I'm not arguing that the Pecora investigation had any direct hand in drafting the Glass-Steagall Act, I do think it's fair to say that it had a direct influence over its passage.

The committee began its hearings under two chief counsels who were rather weak and didn't get very far. In fact, it was a very frustrating experience for the first 9 months of the investigation until January 1933, when the outgoing chairman hired Ferdinand Pecora out of the New York district attorney's office to try to wrap up the investigation between January and March.

Pecora decided to broaden the investigation and his first witness that he called was Charles Mitchell, who was the president of the National City Bank and who had in fact come up the ranks through the National City Co., which was its security affiliate. Mitchell was a very famous banker at this time, probably one of the most prominent in terms of his advising Presidents during the 1920's and advising Congress. He made a very dramatic witness as the leadoff on the new Pecora investigations.

Pecora had gotten enough subpoena power to go through all the bank's records and came up with enough information to indicate that the National City Bank had used its security company to bail out its bad loans during the 1920's at the expense of its investors.

In one instance, for instance, the Cuban sugar industry had defaulted on several large loans that it owed to the National City Bank. The bank then issued $50 million in its own stocks, transferred the capital to the National City Co., which then bought controlling interest in the Cuban sugar companies, which used the money from that to pay back the National City Bank on the loans that it had defaulted on.

These revelations caused Charles Mitchell to resign as president of the National City Bank and for the bank to declare that it was separating its ties with its securities affiliate. This was even before the Glass-Steagall Act was passed.

Also at this time the Nation's largest bank, the Chase National Bank, voluntarily announced that it, too, was separating from its securities affiliate. On March 9, 1933, Chase's president, Winthrop Aldridge, announced that:

> It was impossible to consider the events which took place during the past 10 years without being forced to the conclusion that intimate connection between commercial banking and investment banking almost inevitably leads to abuses.

Interestingly enough, during the investigation itself, they brought the former president of the bank as a witness and during that testimony they discovered that National City's securities affiliate was short-selling on its own bank stocks and at this stage Mr. Aldridge was president of the bank and he stood up and came before the committee and apologized for this action and said that it would not take place as long as he was president of the company.

In May 1933, shortly after Senator Glass introduced the latest version of his bill, Pecora called his most dramatic witness, and that was the most famous banker in the country at the time, J.P. Morgan, Jr. This hearing drew press attention I would say that would be comparable only to the Iran-Contra hearings that are going on now. It packed the Senate caucus room. It brought in headlines every day. It focused national attention on the Nation's banking and securities industry and on the reform legislation.

Among other things, Morgan's testimony indicated that Morgan and his partners had paid no income taxes for the last several years prior to 1932, that the partners in this private bank sat on a network of commercial banks, directors and corporate directors, the Federal Reserve Act. There was a conspiracy brewing in opposition to any meaningful reform, he warned. Many of the witnesses then appearing before the Banking and Currency Committee seemed to have been learning their lines in a "banker's night school." [65]

Not long after the full committee's hearings had ended, a spokesman for the Chase National Bank, in an April news release, deplored the banking reforms contained in the Glass bill and suggested, furthermore, that the net effect of an enactment of the divorce provision would be to throw investment banking back into strictly private hands. Senator Glass, the article subtly implied, was unwittingly playing into the hands of his real enemies—the private bankers, who under the current law could not be controlled at all by the federal government. The growth of the commercial bank affiliate system was praised in the article as a commendable evolution, and, in fact, this change in the financial structure was deserving of full credit for smashing whatever "money trust" really might have existed before the 1920's.[66]

It was true, of course, that no representative of any investment banking firm had appeared before the Senate committees to protest the divorce clause, or any other feature, of the bill. No one from J. P. Morgan & Co. or Kuhn, Loeb & Co. had made the trip to Washington. Thus, internal Wall Street rivalries seem to have been working to Glass's advantage on the divorce issue. The older investment banking houses who had been losing the competitive battle with the more aggressive commercial banks now thought they saw an opportunity to reestablish their former dominant position in the underwriting field. On the divorce issue then, it seems reasonable to conclude that Glass and the private banking fraternity had found a compatible goal. Both wanted to return to a financial structure in which banks confined themselves to narrow functional services; both wanted to readjust structure so that it conformed more closely with the dominant banking theory.[67]

In May 1932 Glass made a dramatic speech. From the Senate floor, he resurrected an old legal opinion, written in 1911 by Solicitor General Frederick Lehman, and concurred with by Attorney General Charles Wickersham, that questioned the legality of the emerging affiliate system. After detailed investigation of the National City Company, a subsidiary of the National City Bank, Lehman had concluded that the arrangement was an "usurpation of Federal authority and in violation of Federal law." [68] However, for some unknown reason, no legal action was taken by the Taft administration to implement the findings of the Solicitor General. The original copy of the Lehman opinion had disappeared from the files of the Justice Department sometime prior to 1913, so that only a carbon copy remained. As to why the report was missing and why the government had never filed suit, Glass could only "conjecture," but the implication was unquestionably that sinister motives had played a significant role in the administration's decision. As far back as the McFadden hearings, Glass had hoped for some tangible proof of the illegality of the affiliate system; now, he believed, he had it. The union of commercial and investment banking was, thus, being further threatened by the alleged invalidity of the original marriage contract.[69]

What over twenty years ago had appeared like nothing more than a minor acquiescence to Wall Street interests, as revived by Glass, now began to take on more of a conspiratorial appearance. By 1932, after three years of business contraction, such allegations met an understandably receptive public. In addition, this confirmation of his earlier suspicions about the probable illegality of the affiliate system not only gave him intense personal satisfaction, but also made his demand for outright separation seem more justifiable and less radical. This episode deepened Glass's personal commitment to the divorce provision, but as a political pragmatist, he realized that the prospect for final passage was still very slight.

There was hope among Glass's supporters of bringing the complete bill quickly before the Senate in June of 1932, when it was given a preferential position on the upper chamber's calendar.[70] But the likelihood of lengthy floor debate plus a political desideratum to prevent "agitation" on the banking question just before a national campaign prompted the Republican leadership to remove the bill from the preferential list. It was to be held over until the December session, when Glass was assured it would receive early consideration.

That summer, Glass was instrumental in formulating the Democratic platform for the 1932 campaign. In addition to promising regulation of the security markets, the platform also called for:

> "The severance of affiliated security companies from, and the divorce of the investment banking business from, commercial banks. . . ." [71]

Glass used this issue in an extended campaign speech for Franklin Roosevelt to a national radio audience just before the election. In an address lambasting the Hoover administration for its financial ineptitude, Glass explained how "with insatiable avarice, great banking institutions, through

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[65] COMMERCIAL AND FINANCIAL CHRONICLE, February 6, 1932.

[66] *Ibid.*, April 30, 1932.

[67] It would be an interesting study to ascertain whether eastern Senators, indebted to the general financial community, felt more allegiance to predominantely commercial bankers or to investment bankers during this period.

[68] HEARINGS ON STOCK EXCHANGE PRACTICES, Senate Banking and Currency Committee, 73rd Congress, 1st sess. (1933), p. 133.

[69] COMMERCIAL AND FINANCIAL CHRONICLE, May 14, 1932.

[70] *Letter from Glass to Parker Willis, April 25, 1932*, CARTER GLASS PAPERS (University of Virginia Library, Charlottesville). A fine guide to the Glass collection is Elbert J. Kincaid's INVENTORY TO THE CARTER GLASS PAPERS (Brooklyn Institute, 1958). Hereafter this collection will be referred to as the GLASS PAPERS.

[71] PROCEEDINGS OF THE DEMOCRATIC NATIONAL CONVENTION, 1932 held in Chicago, Illinois, June 27-July 2, 1932 (Washington, 1932).

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their lawless affiliates" had unloaded billions of dollars of worthless securities on the American public.[72] It was generally agreed to have been one of the most effective speeches of the whole campaign.

Meanwhile, the bill's opponents were sharpening their arguments for the upcoming Congressional session. In late October, the Investment Bankers Association of America held its annual convention in White Sulpher Springs, West Virginia. The association's president, Allan Pope, in his opening address, acknowledged the sincerity of those legislators who were under pressure from small investors for reform; but he despaired at "their general bitterness" toward the business community as a whole and "directed against bankers in particular with unprecedented unfairness."[73] Pope, who had testified at the committee hearings, now predicted that some parts of the proposed legislation would bring "ruin upon our government, our people, our banks and bankers." The Glass bill failed to reach the fundamental wrongs—overly aggressive selling methods and low margins. There was really nothing the government could do to improve the situation, he concluded: "We alone control the power to correct it."[74]

However, the subsequent election of Franklin Roosevelt brightened considerably the prospects for the eventual passage of a Glass Banking Bill. Positive Congressional action during the 1932-1933 winter session seemed like a real possibility after the President-elect, without commenting specifically on any of its actual provisions, gave the legislation his general endorsement.[75] In fact, after reflecting upon the

eventual changes in the legislative as well as the executive branch as a result of the Democratic victory, Glass saw himself in a position, where for the first time he could realistically anticipate keeping the divorce provision in the final version of the bill. At this point he could feasibly make a political commitment to the separation of commercial and investment banking. The November elections then, in my opinion, virtually sealed the fate of the affiliate system and the union of the two banking functions that had grown to such proportions within that system. Thereafter, any chance of a compromise calling simply for examination and regulation by the government was remote. When some form of a Glass Banking Bill finally passed, it would include a divorce provision to take effect at some future date; only the length of the interim period had become negotiable.

With the probability that any banking legislation enacted after the incoming administration took office would be harsher on the financial community than the Glass bill as it then stood, President Hoover gave the Senate Republican leaders approval to proceed toward an early vote in the lame duck session. In January the bill was taken up. The American Bankers Association, in a memorial to Congress, altered their original position and gave support to the general tenets of the bill. The only provision on which the ABA still expressed any grave reservations was the divorce clause.[76] The Advisory Council to the Federal Reserve Board, a group of businessmen and bankers from all across the country, also cautioned that a separation of commercial and investment banking would be detrimental to banking and the public interest.[77] As a concession to these and other critics, the original Glass plan, giving banks five years to comply with the divorce decree, was resubmitted in place of the three-year limit suggested by the Federal Reserve

Board.[78] On January 25, 1933, the Glass Banking Bill passed the Senate by the wide margin of 54 to 9.

President Hoover then stepped forward and recommended the bill to the House for immediate passage. However, the House exhibited little interest in the Glass reforms. The main debate there on matters pertaining to the financial community was over a plan to provide federal guaranties of bank deposits. House members were continually being urged by their constituents to take some definite action to halt the persistent wave of bank failures. It soon became obvious that nothing further would be done about the Glass Banking Bill until the next Congress convened.

The changes in Congress were from Glass's point of view somewhat of a mixed blessing. True, many of the men who were beholden to financial and banking interests and who believed strictly in the status quo had been removed; but, on the other hand, their replacements represented a new element seemingly intent on radically meddling with the financial structure and, even worse, pursuing inflationary monetary policies. His fear that President Roosevelt was determined to follow the inflationary path was one of the major factors in his decision not to accept the cabinet post of Secretary of the Treasury for a second time. The other reasons were his advanced age, he was 75, and Roosevelt's refusal to let him name his own departmental assistants. He wanted Russell Leffingwell of J. P. Morgan & Co., his assistant during the Wilson administration, to be his undersecretary.[79] When his worst fears on the inflation issue eventually came true, Glass began to sour on the New Deal, and he finally became one of the President's bitterest critics.

Outside of the political arena, a number of factors were developing that would make the realization of Glass's maximum goal on the affiliate issue achievable without a really formidable protest from the financial community. First, there was the preoccupation in the spring of 1933 with the possible effects of two even more ominous threats to the sanctity of the status quo—the movements that led to the creation of the F.D.I.C. and the passage of the Securities Act of 1933, modeled on the English Companies Act. Compared with these truly revolutionary proposals, an imposed divorce of commercial and investment banking seemed like only a mild inconvenience. What Hoovers' review team had called radical and dangerous, now appeared to the bankers themselves far more conservative and constructive. Just as in the debate over the McFadden Act in the mid-twenties, when the affiliate question was overshadowed by the controversy over the extention of branch banking privileges, so again in 1933 it was forced to take a backseat position in the political world to other more pressing issues.

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[72] COMMERCIAL AND FINANCIAL CHRONICLE, November 5, 1932.

[73] PROCEEDINGS OF ANNUAL CONVENTION, Investment Bankers Association of America, October 1932 (Chicago, 1932), at 8.

[74] *Loc. cit.*

[75] *Letter from Parker Willis to Glass*, November 19, 1932, GLASS PAPERS. Willis described the interview he had with FDR in Albany in this very revealing letter. The president-elect hoped for passage in the upcoming short session in order to save time at the beginning of his administration. "Get as much as you can now," he told Willis, "and we can amend the bill later if necessary."

[76] COMMERCIAL AND FINANCIAL CHRONICLE, December 24, 1932.

[77] *Ibid.*, January 14, 1933.

[78] *Letter from Eugene Meyer to Glass, May 7, 1932*, GLASS PAPERS. In a letter marked confidential, Meyer explained how he had changed his mind about the proper interval for phasing out the affiliates. Because of the practical problems, he now favored a five-year interim rather than three years.

[79] Moley, *op. cit.*, at 81.

Actual conditions in the securities markets were also instrumental in making the divorce less objectionable to commercial bankers. Because of the economic contraction, few companies were trying to issue new securities. The investment banking business was, therefore, dormant. Yet, some banks still had personnel on their payroll whose only justification had been the previously very active securities markets; these people were now just so much excess baggage. New restrictions on future services could provide a ready excuse for discharging those employees who were primarily connected with currently unprofitable departments. In addition, no one was prepared to predict how soon, if ever again, this commercial banking sideline might be able to pay its own way.[80]

The precipitating event which caused Glass's opponents on the divorce issue to virtually surrender their whole case was, as Arthur Schlesinger, Jr. cited, the concurrent Congressional investigation into stock market practices. The rise of the larger banks' affiliates to a prominent position in the long-term capital market made them vulnerable, along with the private houses, to criticisms of what was wrong with the way investment banking functions were being carried on in the United States. Within this context, it is important to note, however, that most of the so-called abuses of the affiliates were characteristic of many other institutions and firms directly involved in the securities markets. During the first week in March, Charles Mitchell of the National City Bank was questioned sharply at the hearings about the activities of the National City Company.[81] It was a humiliating performance. On March 7, 1933, the National City Bank, under the signature of its new chief executive officer, James Perkins, announced that it was voluntarily liquidating its security affiliate.

On the following day, March 8, Winthrop Aldrich, who had succeeded Albert Wiggin at Chase National Bank at the beginning of the year, announced that the Chase Securities Company was being separated from the parent institution. Part of his statement read:

> "I heartily commend the action of National City Bank in taking steps to divorce its security affiliate. . . . It is impossible to consider the events which took place during the past ten years without being forced to the conclusion that intimate connection between commercial banking and investment banking almost inevitably leads to abuses." [82]

The New York Times suggested that the anticipation of a broadened Congressional investigation into the practices of other bank affiliates had prompted the Chase announcement. By the end of 1933, over one thousand employees of the Chase Securities Company had been released.[83]

In response to these economic and institutional developments, Senator Glass took the opportunity to reduce the interim phase-out period from five years to two years and then, just before final passage, one year. However, in order to gain that final passage, it was necessary to deal with those groups adamant about a deposit guarantee. Glass opposed the general principle of deposit insurance, but the House was determined to accept no substantial reform unless it included an insurance plan. With great reluctance, Glass agreed to incorporate such a plan in his bill.[84] By the end of May 1933, the Glass Banking Bill and the Steagall Bill, the basis for the F.D.I.C., had passed their respective houses and were sent to conference. On June 13, the Banking Act of 1933, sometimes called the Glass-Steagall Bill, passed both houses. It included a provision decreeing the complete divorce of commercial banking and investment banking by June 13, 1934. Because President Roosevelt felt that the deposit insurance plan was a radical and unworkable program, he somewhat hesitantly signed the bill. In his most recent book, Raymond Moley in a discussion of the Glass bill states that "Roosevelt was sympathetic, but had no active part in pressing for . . . passage." Most of the people in the White House were busy with their own projects, he recalls, and "Glass was left to his own devices." The bill, Moley concluded, can "hardly be classed as a New Deal measure." [85]

VII

Conclusion

Perhaps in the end the bankers themselves, who had always been under the influence of orthodox banking theory, were relieved to have the assurance that no competitive pressures would be allowed to emerge in the future, as they had in the past, and cause structural deviations from textbook principles. Certainly, the older investment banking firms welcomed relief from aggressive commercial bank competitors. Hereafter, competition would be contained within the narrow functional banking fields of commercial and investment banking.

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[80] Goldschmidt, *op. cit.*, at 115.

[81] Schlesinger, *op. cit.*, at 435-438.

[82] NEW YORK TIMES, March 8, 1933.

[83] *Ibid.*, March 9, 1933.

[84] Moley, *op. cit.*, at 81.

[85] *Ibid.*, at 317.

However, it would be remiss not to point out that extremely strong ties still remained between the two banking functions. Investment bankers continued to borrow much of their working capital from commercial banks. If the proponents of an alteration in the financial structure had as one of their goals the complete protection of commercial bank depositors from the risks of unsalable security issues, it was then only partially successful. Nonetheless, after 1934, the legal separation did coincide more closely with the established English theory. Conflicts between financial reformers and the commercial banking community thereafter subsided significantly.

In summary, this paper has tried to set out a framework for a fuller, more penetrating analysis of the relationship between commercial and investment banking during one segment of American history. It has briefly traced the institutional changes during the latter part of the nineteenth and early part of the twentieth centuries which brought these banking functions closer together. This institutional development violated the established theories of sound banking practice, but until the depression such deviations appeared to have no real significance. After the stock market crash, much attention was given to the period from 1927 to 1929 when the unification movement had so rapidly accelerated. In an energetic effort to reform the system, Carter Glass proposed an absolute divorce of all commercial and investment banking activities, and the persistence of the depression contributed greatly to the final enactment of Glass's proposal.

The final separation also came in part because no new banking theory had come forth to overwhelm the established ideas. Although institutional changes had been evolving over a long period of time, this trend did not stimulate any significant theoretical innovations. During the formal hearings, advocates of the status quo generally defended the unified arrangement of banking services only because it already existed and had been found useful. In no instance did they offer a theoretical support for their views. Instead, they preferred to stick to practicalities and to avoid being led off into a discussion of the abstractions of banking theory. It was in this area that their case was weakest and both they and Carter Glass knew it. As a consequence, it is understandable why Glass tried to readjust the banking structure in the way that he did. Basically, he was trying to recreate a banking system to which the old ideas of sound banking practice would be applicable. That Glass's view ultimately prevailed can be partially attributed to the unchallenged predominance of old ideas.

While much effort has been devoted to discrediting the economic truisms of this generation of Americans, not enough has been devoted to understanding to what extent old-fashioned beliefs influenced the behavior of the participants in our financial drama. Too often the economic theories have been ignored, but the legislative achievements, based on those theories, praised. Without attempting to ascertain whether the divorce was a "good" thing or a "bad" thing, it can, nevertheless, be noted that in the 1960's a trend toward institutional diversification similar to developments in the 1920's has emerged. This suggests that a tentative conclusion about the earlier movement is that it was a natural economic development cut short temporarily by an ill-timed depression.

I could not resist the temptation to close with an ironic footnote. In England during 1931, the Macmillan Committee on Finance and Industry made its report to Parliament. The committee had been appointed to investigate the sluggishness of British capital markets and to recommend needed improvements. The report praised the close cooperation between commercial banks and their corporate customers in the American system and commented on the vitality this brought to our security markets. English banking theory, the report concluded, should be altered somewhat to conform with American practice.[88]

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[88] PROCEEDINGS OF ANNUAL CONVENTION, Investment Bankers Association of America, October 1933 (Chicago, 1933), at 5.

Appendix I

Percentage Participations in All Bond Issues by All Houses, 1927-1930

Type of Institution	1927	1928	1929	1930
National bank affiliates	12.6	8.9	17.6	33.6
Other bank affiliates	8.0	11.5	27.2	20.8
Commercial banks & trust companies (directly)	16.2	11.6	6.3	6.8
Subtotal	36.8	32.0	51.1	61.2
Private investment banks	63.2	68.0	48.9	38.8
Total	100.0	100.0	100.0	100.0

Source: Nelson Peach, *The Security Affiliates of National Banks* (Baltimore, 1941), p. 110.

Appendix II

Provisions of the Banking Act of 1933

In addition to separating commercial banking and investment banking and establishing the Federal Deposit Insurance Corporation, the Bill had numerous other provisions.

1. Restrictions upon the use of bank credit for speculation.
   Each federal reserve bank was to keep itself informed as to the character of the loans of its member banks. The Federal Reserve Board was given the power to suspend a member bank from the use of the system's credit facilities if, in the judgement of the Board after previous notice and hearing, the bank was making undue use of its credit for speculative purposes.
2. Minimum capital for new national banks.
   Raised to $50,000—up from $25,000.
3. Mutual savings banks and Morris Plan banks may become members of the Federal Reserve System.
4. Branch Banking.
   National banks were made subject to the regulations applicable to state chartered institutions. Branching became strictly a local issue.
5. Group Banking.
   Bank holding companies were required to obtain a permit from the Federal Reserve Board before they were allowed to vote their stock provided they owned over 50% of a bank's outstanding stock.

6. Elimination of interest on demand deposits.
    Banks were not allowed to pay interest on any deposit kept on demand. This included the balances carried by rural banks in the money centers.
7. Regulation of interest on time deposits.
    The Federal Reserve Board was given authority to regulate the interest rate paid by member banks on time and savings deposits.
8. Regulation of loans to bank officers.
    Loans by member banks to their executive officers were prohibited.
9. Removal of bank officers or directors.
    Any officer or director who continued to violate the banking laws or continued to engage in unsafe or unsound banking practices, after having been properly warned, could be removed from his position in the bank.

Source: Howard Preston, *The Banking Act of 1933*, AMERICAN ECONOMIC REVIEW, (December, 1933) at 590-595.

Employer-Connected Child Day Care Center is Tax-Exempt

One of the problems facing banks and other businesses that hire a substantial number of women is the quandary of what do these ladies do with pre-school and school-age children? While it's sometimes possible to work around the problem by arranging part-time work or split hours, a preferable solution would be an educational day care center. One of these, operated in conjunction with a corporation and financed by federal grants and contributions of cash and services from the company, has been declared tax-exempt as a charitable or educational organization under I.R.C. Section 501(c)(3).

The center enrolled children of employees of the company, children of parents employed in nearby businesses and children of parents recommended through antipoverty and welfare agencies. Employment by the company did not automatically guarantee the right to have a child attend the center. Selection was on the basis of financial need of the family and the child's needs for the care and development program. The school was staffed by professional teachers, nurses and social workers.

Ruled the I.R.S., by providing education based on financial needs of the family and the need of the child for the program, the organization is performing a charitable activity. And by providing pre-school age children of working parents with an educational program, the organization is advancing education, particularly since the center made frequent field trips to the nearby businesses to acquaint the children with what their parents did. Rev. Rul. 70-533, 1970 I.R.B. 42, 13.

and that they had issued preferential stocks to major political figures in both parties.

As a result of this revelation, Walter Lippmann wrote that these hearings demonstrated "that no set of men, however honorable they may be and however good their traditions, can be trusted with so much power and the opportunity for personal gain which it carries with it."

Ironically, Senator Glass had no use at all for these Morgan investigations and he didn't like Pecora either, but at the same time, the Morgan testimony really facilitated the passage of the Glass-Steagall Act.

Would you like me to stop, Senator?

The CHAIRMAN. Well, thank you very, very much, Professor Ritchie.

[The complete prepared statement of Donald A. Ritchie follows:]

Historical Origins of the Glass-Steagall Act

Statement of Dr. Donald A. Ritchie
Associate Historian, Senate Historical Office
Before the Senate Committee on Banking, Housing, and Urban Affairs
July 30, 1987

Mr. Chairman and members of the committee, I am pleased to have this opportunity to discuss the historical origins of the Glass-Steagall Banking Act. President Franklin D. Roosevelt signed this act into law on June 16, 1933, at the end of his administration's "First Hundred Days." But Glass-Steagall was not a "New Deal" bill. Its impetus came almost entirely from Congress, and its conception dated back to the Progressive era at the beginning of the twentieth century. In addition, the Senate Banking Committee's dramatic expose of Wall Street banking and securities practices created a favorable political climate for the Glass-Steagall Act, and persuaded the president to sign it.

Glass-Steagall's major provisions can be traced to Progressive era roots. Its principal author, Virginia Senator Carter Glass, had served as chairman of the House Banking Committee when it drafted the Federal Reserve Act of 1913. In the two decades that followed, Glass worried about the thousands of banks that remained outside the Federal Reserve System, and sought to bring them under more centralized control. At least 5,500 banks failed during the prosperous 1920s; most of them small, undercapitalized state banks. Glass also consistently opposed the movement of commercial banks into the investment field, for what he called "stock-gambling purposes." He later identified banking investment affiliates as "the largest contributors" to the economic disaster that occurred in 1929.

Senator Glass was a staunch conservative, but his concerns were mirrored by the liberal reformer Louis D. Brandeis in his influential book, Other People's Money, and How the Bankers Use It, published in 1914 before Brandeis went on the Supreme Court. Drawing from the findings of the "Pujo Investigation" of the House Banking Committee, Brandeis warned that a "Money Trust" of powerful bankers was exerting excessive influence over industry by underwriting stocks and by serving as corporate directors. Still another Progressive era banking proposal was federal insurance for savings deposits, advocated by presidential candidate William Jennings Bryan. Representative Henry Steagall of Alabama had first introduced legislation for deposit insurance in 1923.

President Herbert Hoover was also a product of the Progressive era, having served in Woodrow Wilson's administration. Shortly after Hoover became president in 1929, he attempted to stop "the orgy of speculation" on Wall Street, but was frustrated when banking investment practices counteracted Federal Reserve Board efforts to tighten credit for speculative purposes. In his reelection campaign in 1932, Hoover supported banking reforms and declared that the American people "must be relieved from conditions which permit the credit machinery of the country to be made available witnout check for wholesale speculation in securities with ruinous consequences to millions of our citizens and to our national economy."

In the four years after the 1929 stock market crash, another five thousand banks permanently closed their doors. During these years, Senator Glass introduced a series of bills designed to curb the speculative use of bank credit. These bills came under intense fire, both from banking associations, which called for less regulation rather than more, and from such populists as Huey Long, who were suspicious of more centralized control of banking. Glass' first bill in 1930 called only for national banks to file regular reports on their security affiliates. Later versions proposed separating securities affiliates entirely. But these bills failed to pass, due both to bank lobbying and to Senator Long's filibusters. The Glass-Steagall bill that passed in 1932 liberalized Federal Reserve discount provisions but did not address the issues of securities affiliates or federal deposit insurance.

In 1932, the Senate Banking Committee launched an investigation into stock trading, at President Hoover's request. These were the hearings that eventually became known as the Pecora investigation, after the committee's energetic counsel, Ferdinand Pecora. They had the advantage of bipartisanship, having begun under a Republican administration, with a Republican committee chairman, and continued under a Democratic administration and a Democratic chairman. In every way, Pecora's inquiry into Wall Street was a model Senate investigation: it conducted extensive research, uncovered startling facts, fully publicized its evidence to educate Congress and the public, and facilitated the enactment of such landmark legislation as the Glass-Steagall Act, the Federal Securities Act, the Securities and Exchange Act, and the Public Utilities Holding Company Act. While the Pecora investigation did not have a direct hand in drafting these bills, I think it is fair to say that it directly influenced their enactment.

Before the Banking Committee began its investigation, stock trading on Wall Street went entirely unregulated by the federal government. The New York Stock Exchange was often compared to a private club, and such private banks as J.P. Morgan & Company, never opened their books to government auditors. The Pecora investigation concluded that this absence of public regulation had led to speculative excesses even among the most reputable bankers and brokers. As Otto Kahn, senior partner in the private banking house of Kuhn, Loeb and Company, told the committee: "We were all sinners during that time, Mr. Pecora, or, if not sinners, we were all grossly mistaken or affected beyond our powers to resist by the then prevailing mania or greed." Kahn added: "if we indulge again in practices that are socially, economically, and, from the point of view of the country, undesirable, I think the policeman ought to step in."

Under their first two counsels, the Banking Committee hearings produced few results, but this changed when Ferdinand Pecora was hired as counsel in January, 1933. Pecora immediately broadened the scope of the investigation and called as his first witness Charles Mitchell, president of the National City Bank. Mitchell had risen to prominence in the National City Company, the bank's security affiliate, and personified the banker as an aggressive stock salesman. Armed with extensive subpoena power, Pecora's staff combed through the National City records, and when Mitchell appeared on February 21, 1933, Pecora demonstrated that National City Bank had used its security company to bail out its bad loans, at the expense of its investors.

In one instance, when the Cuban sugar industry defalted on several large loans from the National City Bank, the bank issued $50 million in new stocks, then transferred the capital to the National City Company, which bought controlling interest in the Cuban sugar companies, which were then able to repay their bank loans. Such revelations caused Charles Mitchell's resignation as president of the National City Bank, and led the bank to sever all connections with its investment company--before Glass-Steagall became law.

The nation's largest commercial bank, Chase National Bank, also separated voluntarily from its investment house. On March 9, 1933, Chase's new president, Winthrop Aldrich, announced that it was "impossible to consider the events which took place during the past ten years without being forced to the conclusion that intimate connection between commerical banking and investment banking almost inevitably leads to abuses." Aldrich declared himself entirely sympathetic with Senator Glass' proposed legislation to divorce security affiliates from commercial banks, and suggested that the bill did not go far enough. Several months later, after the Banking Committee's investigation revealed that the Chase Securities Company had been short selling its own bank's stocks, Winthrop Aldrich asked permission to address the committee. He promised: "As long as I have anything to do with the management, the market in Chase stocks shall not be affected by the cooperation of trading accounts by affiliates of the bank."

In May, 1933, shortly after Senator Glass reintroduced his banking bill, Pecora called as a witness the nation's most famous banker, J.P. Morgan, Jr. Drawing national press and public attention comparable to the Iran-Contra hearings, Morgan's testimony revealed among other things that Morgan had paid no income taxes in 1931 and 1932; that the partners in his private bank sat as directors of an extensive network of commercial banks and corporations; and that Morgan & Company had issued preferential invitations to prominent American politicians from both parties to purchase stocks below the market rates. Columnist Walter Lippmann wrote that the Morgan hearings demonstrated "that no set of men, however honorable they may be and however good their traditions, can be trusted with so much power and the opportunity for personal gain which it carried with it."

Although Senator Glass disapproved of the Morgan inquiry, and showed open antagonism to counsel Pecora, his banking bill owed much to the hearings. Before J.P. Morgan testified, press commentators had given the Glass-Steagall bill little chance of passage during that special session of Congress. After passage of the Emergency Banking Act in March, 1933, presidential and congressional attention had been diverted away from banking to other New Deal reforms. Senator Glass and House Banking Committee Chairman Steagall were at loggerheads, not over the separation of banking and securities functions, but over federal deposit insurance, which Steagall favored and Glass opposed. And President Roosevelt warned that he might veto a bill that committed the federal government to insuring savings deposits.

Yet, just days after Morgan took the stand, the Senate passed the Glass bill by acclamation, and by early June (with the Morgan inquiry still in progress) a conference committee had worked out differences between the House and Senate versions. The daily headlines about Morgan--including the famous incident in which a circus promoter entered the Senate Caucus Room and slipped a midget into J.P. Morgan's lap, allowing press photographers to capture the

humbling of a once Olympian banker--helped stimulate Congressional action.

The final version of Glass-Steagall reduced from two years to one the time in which commerical banks must divorce their investment companies. Thereafter, commercial banks could underwrite only government securities. The officers of national banks had until 1935 to divest themselves of any loans they had received from their own institutions. The bill increased the Federal Reserve Board's control over bank credit and gave the Board control over all foreign operations of member banks. National banks were permitted to operate branch banks wherever states permitted branch banking. By far the most controversial provision was the act's creation of a Federal Deposit Insurance Corporation. The banking associations, Senator Glass, and President Roosevelt all shared deep distrust of deposit insurance, which subsequently became the law's most universally acclaimed achievement. The Senate and House adopted the conference report on June 13, and the president signed the bill on June 16. At the signing, President Roosevelt, who had never been more than peripherally involved with the bill, commented that Glass-Steagall had "more lives than a cat."

This has been just a brief sketch of the personalities, issues and events leading to passage of the Glass-Steagall Act in 1933. With my testimony, I am including copies of two articles that I have written, "The Pecora Wall Street Expose," and "The Legislative Impact of the Pecora Investigation," to provide further details on the colorful history of those hearings. I would also direct the committee's attention to Ferdinand Pecora's memoir of his investigation, Wall Street Under Oath. In addition, the Banking Committee's hearings from 1932 to 1934 fill some twenty printed volumes of testimony, as well as one hundred and seventy-one boxes of records at the Legislative division of the National Archives. The sheer bulk of these records stand as testament to the lengthy and diligent work of the Pecora investigation.

The Banking Committee's hearings uncovered the evidence that prompted Congress and the president to act. Its legacy took the form of corrective legislation, which for the past half century has shaped American banking and securities trading. The history of the Glass-Steagall Act shows that it was not a precipitous response to the stock market crash and Depression, passed in a rush along with other New Deal legislation, but that it grew out of decades of concern over banks involvement in stock trading, irresponsible handling of investors, bailing out of bad bank loans, manipulating bank stocks, and extending credit that overheated the stock markets. The bill's history also demonstrates that its reforms had strong bipartisan support. Glass-Steagall represented Congress' attempt to put a lid on the speculative excesses of the 1920s, and to restore public confidence in the American banking system. Any effort to revise the act should take into consideration those practices that it sought to abolish, and that the Pecora investigation exposed so vividly, to prevent their reoccurrence in the future.

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The Pecora Wall Street Exposé
1934

by Donald A. Ritchie

Suspicious, fearful, and frustrated, the Depression Congress of 1932 filled its hoppers with a record number of resolutions for investigation. Most sought some explanation for the stock market crash, business liquidations, and bank failures. Unemployment paralyzed the nation, demanding exposure of the conditions and persons responsible. Few of these investigations ever materialized—only the Senate Banking and Currency Committee's examination of Wall Street captured the public's attention. After the committee had stumbled aimlessly through a maze of incomprehensible financial data under a series of inept counsels, the investigation at last succeeded when it gained the leadership of Ferdinand Pecora and his staff. So thoroughly did Counsel Pecora dominate the proceedings that *his* name, rather than the committee chairman's, became irrevocably identified with the hearings. The Pecora probe, with its careful documentation of banker and broker misdeeds, and its contributions to corrective legislation, set a worthy model for future congressional investigations.

In the twenty years since the Pujo Committee hearings on the "Money Trust," the American economic structure had grown disastrously worse. Of fifty billion dollars' worth of stocks sold in the United States during the 1920s the House Commerce Committee estimated, half had been "undesirable or

Arthur M. Schlesinger, Jr. and Roger Bruns, eds.,
Congress Investigates: A Documented History, 1792-1974
(New York: R.R. Bowker, 1975).

worthless." Securities houses of the most reputable banks manifoldly increased their profits at the expense of their own clients. Powerful investment bankers continued to fill key corporations' boards of directors. Overly-optimistic loan programs threatened vast banking chains with domino-like collapse. Utility holding companies teetered precariously upon an intricate system of interlocking directorates with little regard for corporate efficiency or local requirements. Concurrently, the federal government remained willfully ignorant of stock exchange and private banking operations. "The business of America is business," Calvin Coolidge had noted with satisfaction during the 1920s; by 1932 that business verged on bankruptcy.

To a generation of liberals, the market crash and the subsequent Depression verified the prophesies of Louis Brandeis's economic tract, *Other People's Money*. Drawing from the Pujo Committee findings, first in a series of articles for *Harper's Weekly* and then in his book, Brandeis had warned that an amalgamation of investment bankers and insurance companies was using its control of "other people's money" to infiltrate American industry. These "banker-barons" were more concerned about the market value of a corporation's securities than for the value of its product. Worried that their combination of wealth and power had slowly stifled the competitive free market system, Brandeis sounded the alarm: "We must break the Money Trust or the Money Trust will break us." The government, he declared, must demand full publicity on all stock dealings, including bankers' commissions and the extent of the bankers' control over the issuing corporation. "Sunlight is said to be the best of disinfectants; electric light the most effective policeman," he concluded, so full financial disclosure would purify imperfections within the economic system.

Armed with the first new reprinting of the book in twenty years, old and young liberals alike carried its message to Washington with the new Roosevelt Administration. In congressional committee rooms the book became a familiar sight—many witnesses introduced it as proof of their arguments. Legislative drafts emerged verbatim from its pages. The book also provided a historical link between the two great financial investigations, for Brandeis and his followers viewed Pecora's work as the fulfillment of the Pujo investigation.

Economic conditions, political support, and public interest all gave Pecora advantages denied to his predecessor, Samuel Untermyer, counsel for Pujo. Where the Pujo hearings had commenced in a relatively prosperous period, Pecora began his hearings at the nadir of the Depression. Where President William Howard Taft had withheld cooperation from Untermyer, President Franklin D. Roosevelt personally encouraged Pecora, endorsed the hearings, and incorporated their recommendations into his legislative program. The press, hostile to the earlier inquiry, lavished extensive coverage on Pecora, filling columns with his photographs and accounts of his activities. Pecora also benefited from Untermyer's mistakes. Recalling his unsuccessful attempts to gain sufficient evidence, Pecora acquired far stronger subpoena powers than his predecessor. He marched his staff directly into the banks and brokerage houses rather than depend upon his witnesses to produce material voluntarily.

For more than a year Pecora called many of the nation's most prestigious financiers before the public. Repeatedly, he elicited from them such startling admissions of wrongdoing that he stole headlines from even the masterful Franklin Roosevelt. Nevertheless, Roosevelt cheerfully supported the hearings, for their publicity helped counteract business opposition to his financial reforms and aided passage of such controversial measures as the Securities Act of 1933, the Securities and Exchange Act of 1934, and the Public Utilities Holding Company Act of 1935. Constant revelations from the witness stand and revulsion against them distracted the attention of liberal elements within Roosevelt's loose political coalition. At the same time FDR more actively courted the business community through the National Recovery Administration.

In a small part, the Pecora investigations contributed to a reforming rather than a revolutionary spirit in the New Deal's program. At a time of considerable questioning of the capitalist system, the hearings personalized the causes of the Depression. By producing a string of villains, they translated complicated economic problems into moral terms. Bankers, Pecora demonstrated, had abandoned their fiduciary responsibilities. He expended his greatest wrath on the "incompetence, negligence, irresponsibility, or cupidity in the profession." The banking and securities systems, it followed, needed only a change in personnel and stricter governmental supervision so that such abuses might not reoccur. Government regulation of private finance, rather than nationalization or centralization, was the investigation's message and its legislative legacy.

The Banking Committee hearings could claim both the Hoover and Roosevelt Administrations as patrons, and as a result enjoyed unusual bipartisan support. Herbert Hoover, despite his philosophical aversion to government interference with the stock exchanges and other market machinery, took credit for initiating the investigation. These claims, however, deserved some qualification. Early in his presidential term, Hoover had summoned various stock exchange officials for talks on the economy. Worried over the dangers of unrestrained speculation and unrealistically high market prices, but also convinced he had no constitutional right or power to intervene, Hoover urged the exchange leaders to assume more self-discipline over the stock markets. For his efforts he received "profuse promises" but no action. Within months the market crashed, but Hoover clung to his narrow interpretation of government responsibility. To quiet congressional murmurs, the White House issued assurances that "in the long run the system of free selling is better." When a flurry of resolutions from both Republicans and Democrats made some action imminent, the President stepped up his campaign for stock exchange self-reform.

Continually declining markets in 1930 and 1931 led Hoover to lay blame for the economic collapse on the "bear raiding" tactics of professional stock manipulators. These "bears" made commitments to sell stock which they did not own, on the assumption that the stock's price would soon drop. Borrowing equal amounts of stock from cooperative underwriters to cover their sales, they waited until the market sank far enough to buy shares at a lower price than that at which they had agreed to sell. The difference, less a percentage for the underwriters, was pure profit. Frequently short sales like these first involved boosting the stock's price through calculated purchases on different exchanges, and then a sudden burst of sales to bring the price down: the bear raid. When organized pools of speculators abruptly unloaded stock, they often created panic selling among smaller investors, further depressing the market to the bears' financial advantage. Such profiteering on the Depression appeared particularly reprehensible to the Congress. Yet despite their threats of investigation and urgent presidential pleas, the governing boards of the major exchanges refused to outlaw short selling.

Richard Whitney, speaking for the New York Stock Exchange, which handled more than half the nation's stock transactions, expressed the belief that short selling provided badly needed liquidity in times of crisis. Short sellers eventually had to buy stocks to settle their sales, the exchange argued, and thereby provided purchasers during periods of heavy selling. The exchange preferred to retain the practice under limited controls and threaten its temporary suspension as a weapon in cases of emergency. As a concession, the New York Stock Exchange agreed only to prohibit its member firms from lending stocks to short sellers without the original stockholder's written consent, a rule which they predicted would reduce short selling by fifty percent. Hoover, however, considered this action totally insufficient. On February 19, 1932, the day after the exchange announced its new rules, the President met with Republican Senators Frederic Walcott and Peter Norbeck of the Senate Banking and Currency Committee, endorsed an investigation of short selling, and encouraged them to proceed vigorously.

Hoover's fears extended to his political future. Facing a hard reelection campaign that year, he imagined that the bear raiding represented secret Democratic attempts to embarrass his Administration. He reserved his deepest suspicions for such prominent Democratic financiers as Bernard Baruch and John J. Raskob, then chairman of the Democratic National Committee, and he hoped the investigation would reveal their stock dealings. Ironically, while none of these men was engaged in bear raiding, some of the most active bears, like "Sell 'Em" Ben Smith, did time their larger sales to correspond with Hoover's optimistic speeches. They had learned that whenever the President predicted recovery, the market invariably declined.

Acting for Hoover, Senator Walcott had already introduced a resolution allotting $3,000 for an investigation into the specific practice of short selling. Walcott made it clear he wanted no federal legislation to reform the exchanges. Instead, he planned to force the exchanges, through adverse publicity, to adopt stronger rules on their own. This measure proved too tepid for the majority in Congress. Sentiments against the exchanges had grown too powerful, and on March 4 the Senate endorsed an investigation into all stock market practices. To support this investigation they appropriated $50,000, an unexpectedly large sum, considering that the hearings were scheduled to end with the adjournment of Congress in June.

Even after the resolution passed, the Banking Committee made little effort to implement it. The committee had already voted to make Senator Carter Glass's banking reform bill its pending business, and unforeseen altercations and lengthy deliberations on that bill delayed any investigation planning for another month. Its sponsors soon began to fear that the session would close without having opened hearings into stock exchange abuses.

Then, on Friday, April 8, 1932, Hoover received private warnings that bear raiders planned heavy stock sales for the next day, to sabotage his recovery [illegible] to the Republican cloakroom to gather majority members of the Banking Committee. Since Chairman Norbeck was absent, campaigning for reelection in South Dakota, Senator Smith W. Brookhart, an insurgent Republican from Iowa, stood as the acting chairman. But Brookhart allowed the conservative Walcott to take command in spreading word of the "great bear raid." From the cloakroom Walcott telephoned New York Stock Exchange President Richard Whitney and demanded that he provide the committee with a list of all short sellers on the exchange. When Whitney refused to comply voluntarily, Walcott won committee approval to subpoena him. The committee ordered the exchange president to appear on Monday with lists of all stocks sold short in excess of ten thousand shares, and all those who traded in the stocks. Senator Brookhart, long a supporter of a Wall Street investigation, rejoiced in the move. "We are going to look into Mr. Whitney's machine," he promised. "We are going to get the real facts, and we think he knows them."

Chairman Peter Norbeck hurried back from South Dakota to be present when Richard Whitney appeared before the committee's Monday morning session. The hastily called hearings quickly developed into a complete debacle for the committee. Walcott had appointed Claude R. Branch, a soft-spoken and unimpressive lawyer from Rhode Island, as the tentative counsel, but Branch pursued an ill-prepared and fruitless examination of Whitney. The stock exchange president had appeared without the data which the committee had requested, explaining that 175 exchange employees were busily compiling the voluminous records. Deprived of any hard evidence, neither Branch nor the committee could follow any intensive line of inquiry. Innocently, Whitney pleaded no knowledge of any bear raid, nor any widespread short selling. He could not explain "rigging" stock to them, and begged ignorance of "floor pools." The hearings that promised sensational disclosures produced nothing at all, and no bear raid took place that Saturday. Public interest in the hearings faded, the *New York Times* noted editorially, "because of the somewhat foolish anticlimax that has been reached."

Much chagrined at Whitney's easy success, Chairman Norbeck dismissed Branch and hired Philadelphia attorney William A. Gray to continue the examination. Gray had the added advantage of the lengthy short selling reports which the New York Stock Exchange had finally submitted. Since this material consisted entirely of raw data, and Gray had the aid of only one secretary and one financial advisor, he decided not to examine the report. "The exchange furnished information from which you could not get anything unless you studied it for a week," he explained as he reconvened the hearings. Relying on his skillful courtroom tactics to draw out information, Gray immediately recalled Whitney to the stand and led him through a repetition of much of the same questioning that Branch had already conducted. Again, Whitney easily avoided or deflated the questions.

Eventually, Gray realized the futility of his approach and adjourned the hearings to collect and analyze his data. The Banking Committee subpoenaed the general records of ten brokerage firms, and after reading through the material, published the names of 350 bear traders. To Hoover's disappointment, no leading Democrats appeared on the list. "These obviously are dummy names in many cases," Senator Walcott explained bitterly. Again

Gray called Whitney to testify on the exchange's attitude toward short selling, and Whitney continued to profess ignorance of any wrongdoing. "You make rules that are just paper rules," Chairman Norbeck exploded in exasperation. "I ask for proof of that," Whitney countered. "You attend these hearings for a while and you will see," Norbeck assured him. "I have been," Whitney responded wearily. "Yes," Norbeck thundered back, "but up to now you have been running them!" (Reported in the press, Norbeck's last statement does not appear in the official committee transcripts.)

Opponents of the hearings charged that they had done nothing to restore public confidence in the exchanges nor to drive out the bear raiders. Even the once militant Walcott hedged his support. "I am not sure now that short sales depress the market," he admitted. For the more progressive Norbeck, the humiliating hearings and growing public disenchantment with the investigation were infuriating. Storming out of an executive session of the committee, he shouted to reporters: "We are going to carry this investigation through to the end."

Seizing full control of the investigation, Norbeck established a five member steering committee, which he headed, and which noticeably omitted Walcott. The subcommittee then hired four special investigators and an accounting firm to assist Gray in sifting through the mountains of financial records they had accumulated. These new directions produced new witnesses. Percy Rockefeller, nephew of John D. Rockefeller, sr., appeared and confessed that he sold short to cover his losses of "many, many millions of dollars" in the stock market crash. One of his partners in these transactions, Ben Smith, also testified, admitting that he participated in a pooling of R.C.A. stock, along with John J. Raskob and Michael J. Meehan, a heavy contributor to the campaigns of Alfred E. Smith.

In early June the committee called Raskob to testify. Prodding the Democratic national chairman on his trading of General Motors stocks, Counsel Gray attempted to paint him as a short seller deliberately undermining Hoover's programs. Raskob urbanely parried each question, maintaining that he had "always been a bull on America." Bluntly, Senator Carter Glass interjected that "it has been whispered for weeks around the Capitol that this investigation was initiated to involve several prominent Democrats." Gray's badgering of Raskob irritated even Republican Senator James Couzens, who complained, "I don't see where we are drifting." But Gray persisted. Excusing Raskob he subpoenaed Charles E. Mitchell, chairman of the National City Bank, to explain that bank's dealings in speculative Anaconda Copper stocks. Soon after, he launched into a brief examination of the Radio-Keith-Orpheum transactions. When Congress adjourned on July 16, the hearings had produced no significant revelations nor any report on possible further action. Despite rising criticism, Chairman Norbeck vowed to continue. "The bigger things are still to be done."

November's elections brought major political changes. Depression politics swept Hoover out of the White House and obliterated the tenuous Republican majority in the Senate. The Seventy-Third Congress would contain fifty-nine Democratic and thirty-six Republican senators. Florida Senator Duncan U. Fletcher would move to the chairmanship of the Banking Committee. However, the new President and Congress would not arrive until the following March and the Seventy-Second Congress which returned to Washington in December contained an unusually large flock of lame ducks. At first the Banking Committee busied itself with new banking legislation, revisions in the Reconstruction Finance Corporation Act, and numerous monetary proposals, but Norbeck had won a new resolution, increasing the investigation's appropriation and granting it power to examine income tax records in executive sessions. At the same time, he dismissed Gray and began the search for a Democratic counsel.

Early in January, the committee selected Irving Ben Cooper as its new counsel. Fresh from a successful investigation of corruption in New York City as Samuel Seabury's chief assistant, Cooper promised a burst of new enthusiasm. Unexpectedly, though, he demanded complete freedom to conduct his investigation, plus fifty blank subpoenas, and announced he would conduct most of his work in New York. Jealous of their prerogatives, and still sensitive over Gray's misguided tactics, the committee balked at losing control and refused this blank check request. Insulted, Cooper promptly resigned.

Since Norbeck had failed with three counsels, Senator Fletcher approached his longtime friend, former Secretary of State Bainbridge Colby, to offer the position. Colby declined but recommended an associate from the old Bull Moose Progressive party of 1912, who like himself had joined the Democrats in 1916. His choice was Ferdinand Pecora.

Then fifty-one, Pecora had been born in Nicosia, Sicily, and came to the United States at the age of five, where he grew up in the Chelsea area of New York City. At first studying for the Episcopal ministry, Pecora had quit to help support his family. Working in a law office, he financed his own way through New York University Law School. From 1918 until 1930 he served as chief assistant district attorney for New York County. His former boss, District Attorney Jacob Banton, assured the senators that Pecora would conduct the hearings with a "lawyer-like, scholarly manner, without playing up to publicity." During Banton's long illnesses, Pecora had directed much of his office's work. He established an impressive record of convictions in eighty percent of the one thousand cases he handled. His investigations into small "bucket-shop" stock selling operations had introduced him to the murky practices of securities fraud, and he had helped to close 150 such shops through numerous prosecutions. He had also won the conviction of the New York State banking superintendent on bribery charges. Honest and diligent, with a sharp and retentive mind, Pecora would provide the shrewd stewardship missing so long from the investigation.

Offer of the job came as a surprise to Pecora, who thought the committee had already concluded its work. Senator Norbeck assured him that little business remained other than preparing the final report to the Senate, due before Congress adjourned on March 4. When Pecora arrived in Washington, he found the committee's records stuffed into a large file cabinet in Norbeck's office. As he sifted through the material, he was struck by its limited nature and lack of conclusive evidence. The original resolution, he decided, had called for a much broader investigation. Norbeck, who had always shared these opinions, gladly threw his support behind a resumption of the hearings during the few short weeks that remained.

Fully aware of the difficulties of his assignment, Pecora stopped first to

build a staff that he could trust. He drew primarily from the bright and industrious young men who had worked with him in the D.A.'s office. Two young lawyers, David Saperstein and Julius Silver, became his chief assistants, while Frank J. Meehan, an accountant who had worked on the bucket-shop investigations, joined the team as chief statistician. Pecora added other lawyers and accountants, but the committee's tight budget limited his selection. The highest salary he could offer, and take himself, was $3,000 a year, much less than any earned in private practice, even during the Depression. Two old anti-Wall Street warhorses volunteered their services without compensation: Max Lowenthal, a former Harvard Law School student of Felix Frankfurter, who had made a fortune handling stockholder suits against corporations and had written a muckraking account of corporation reorganization in *The Investor Pays*, and John T. Flynn, a highly successful freelance writer, financial editor of *The New Republic*, and lecturer on contemporary economics at the New School. Both men eagerly sought the opportunity to expose business practices they abhorred. Fiery financial iconoclasts, they added a measure of experience and fearless disapproval of the bankers that the younger men might have lacked.

Pecora officially opened his probe in February 1933, a week after the governor of Michigan had declared a "bank holiday" to salvage his state's banking system. Nationwide, more than five thousand banks had suspended operations since the 1929 stock market crash. Now, state after state followed Michigan's example. For the bewildered thousands of depositors who waited in line to withdraw their savings, if possible, the Banking Committee hearings provided a timely financial education.

Aiming for the March 4 deadline, Pecora had hurriedly planned a tentative schedule of witnesses. By chance, Charles E. Mitchell, flamboyant chairman of the National City Bank, became the first target when Pecora read of his impending trip to Europe to discuss stabilization of the lira with Mussolini. Tracking down the banker to his Bermuda retreat, Pecora issued subpoenas for his appearance and for all minutes and records of the National City Bank and its investment affiliate, the National City Company, for the five years prior to October 1929. On Thursday, February 9, Pecora and his staff arrived at the bank's Wall Street headquarters. As they waited, a parade of bank clerks carried in massive volumes of records and piled them into high stacks. Privately, the counsel admitted he felt "appalled by their magnitude." From Thursday night until Saturday night, working almost around-the-clock, he and a corps of accountants combed through the records, photostating all documents they thought useful for the hearings. On Monday, Pecora returned to Washington to conduct a brief inquiry into the Samuel Insull utility company system, while his staff continued to collect and analyze National City data.

By February 21, when the National City hearings began, Pecora had acquired far more damaging information than the unsuspecting Mitchell imagined. With an air of obvious self-confidence, Mitchell swept into the Senate caucus room, with a crowd of lawyers and bank officials surrounding him. No stranger to Washington, the tall, well-tanned, gray-haired Mitchell had advised every Republican President since Warren Harding. A year before he had sat through Counsel Gray's quizzing with no damage to his reputation

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as a responsible banker. Pecora, the short, cigar-smoking Italian immigrant, did not worry him. Yet, within a day under Pecora's persistent questioning, Mitchell's self-confidence waned. He seemed perplexed at Pecora's detailed knowledge of his doings, and the counsel wondered if Mitchell understood how completely they had examined the bank's records. On his first day as a witness, Mitchell admitted he paid no income taxes in 1929 after selling 18,000 shares of stock to his wife to establish a $2,800,000 loss. "That sale was really just a sale of convenience to reduce your taxes?" asked Senator Brookhart. "Yes," Mitchell replied frankly. From 1927 until 1929, he confirmed, he had received bonuses of $3,500,000 from the National City Bank and its investment company, in addition to his annual salary of $25,000.

A large portion of these bountiful profits came from the speculative successes of the National City Company, which had distributed more stocks than any other investment firm during the 1920s. Mitchell, who originally rose to prominence as president of the National City Company and was the firm's greatest salesman, tried to rationalize its more questionable dealings with the bank. Early in the 1920s, for example, the bank had made several large loans to the Cuban sugar industry. In 1927, when these loans were in default, National City Bank issued $50,000,000 in new bank stocks. Without informing the stock purchasers, the bank then transferred this additional capital to the National City Company, which purchased controlling interest in the sugar industry, recently consolidated into the General Sugar Corporation. With this windfall, the sugar industry promptly repaid its debt to the National City Bank. Unweaving the story, Pecora asked: "Is this what is known in the vernacular as 'bailing out' of the bank of a bad loan?" Mitchell protested this implication, but did admit that the stockholders had no idea their money had enabled the investment company to assume the bank's "slow and doubtful" sugar loans. Such conflicting banking and investment interests had troubled the government as early as 1911 when Solicitor General Frederick Lehmann found the National City Company clearly in violation of federal laws for holding the stocks of its parent bank and for engaging in illegal investments. Lehmann's opinion, however, had gathered dust in government files, wholly ignored for the next twenty years.

When Mitchell stepped down, an investor who had placed his fortune in the trust of the National City Company succeeded him to the stand. Edgar Brown of Pottsville, Pennsylvania, explained to the committee how the National City Bank had recommended that he allow the investment company to convert his $225,000 savings in U.S. bonds into a portfolio of stocks. He accepted their advice. When the stocks did poorly, Brown nervously tried to sell, but the agents of the company talked him out of it. "I was placed in the position of one who was about to put his own mother out of the house," he recalled. As a final insult, when Brown's investments collapsed, leaving him bankrupt, the National City Bank refused his application for a loan. Yet, simultaneously, as Pecora's documentation revealed, the bank freely advanced loans on insufficient collateral to its own officers to meet their market commitments.

The National City investigations shocked Wall Street and made headlines across the country. President-elect Roosevelt congratulated Pecora and urged him to carry on the hearings into the next Congress. Chairman-designate Fletcher introduced the resolution to make this possible. On February 27, Charles Mitchell offered his resignation as chairman of the National City Bank, which its board of directors hastily accepted. A week later, the bank's new chairman announced the severing of all connections between the bank and the investment company. The New York district attorney then filed a suit against Mitchell for tax evasion. On March 2, as the committee recessed for the inauguration, Pecora conferred with Senator Norbeck at his office. As the two men looked out of the window towards Union Station, they spied Mitchell, with shoulders stooped, carrying his own luggage across the plaza from his hotel to the railway station. The retinue of bank officials who had accompanied him at the start of the hearings were now nowhere in sight. Mitchell left quietly and alone.

"The money changers have fled from their high seats in the temple of our culture," Franklin Roosevelt proclaimed in his inaugural address two days later. Roosevelt's Administration took office in the midst of a nationwide banking chaos. When the President declared a national bank holiday, the Senate Banking Committee moved to devote its entire energies to banking reform legislation. A week later, when the banks reopened, one of those that remained closed was Joseph Harriman's National Bank and Trust Company. A year before, when the Banking Committee hearings had first begun, Harriman had taken out a newspaper advertisement to warn against them. "Washington is ill equipped to investigate important matters of commerce and finance affecting the public welfare," he warned ominously, "and in the present instance there is no certainty that it will not uncover things much better left sealed." Now, Harriman fled from federal agents before his eventual arrest and imprisonment for misappropriating funds and tampering with his bank's records.

As the senators rushed through the "first hundred days" of Roosevelt's legislative program, Pecora returned to New York and planned new strategy for the investigations. Having finished with the commercial National City Bank, he turned to the practices of the great private banks, and chose their most impressive figure, J. P. Morgan, jr., as his next subject for examination. Arriving in New York, Pecora telephoned Morgan to arrange a preliminary meeting before issuing the banker a subpoena. "Yes, I think I've heard of you, Mr. Pecora," Morgan acknowledged, and invited him down to his office at 23 Wall Street. But Pecora refused his request and insisted that Morgan come uptown and meet him at his own offices. He wanted to make it dramatically clear that the banker faced a representative of the United States government rather than Ferdinand Pecora, the individual.

Pecora's New York office was a small suite of rooms, rented on a monthly basis, in the same building as his private law firm. Filled with second-hand furniture, without rugs, draperies or any other ornamentation, it presented a starkly functional appearance. Morgan arrived with his silver-maned and stately lawyer, John W. Davis, the 1924 Democratic presidential nominee. As Pecora had hoped, the two seemed "impressed by the shabbiness of the room." Without excessive formalities, he proceeded forthrightly to tell them he wanted complete access to the files of J. P. Morgan & Company and any subsidiaries. Morgan, taken out of his baronial surroundings, cut a rather shy and deferential figure. Pecora found him exceedingly courteous and cooperative. Morgan's lawyer, on the other hand, strenuously objected to all his requests as an unconstitutional intrusion into a private citizen's business. A rigid conservative, John W. Davis held sacred the rights of privacy, economic liberty, and the sanctity of private banking. He dismissed most congressional investigations as publicity-seeking, and distrusted all sweeping reforms. Davis insisted that Pecora specify exactly what material the bank should prepare for the committee; he wanted no invasion of the bank's records by Pecora's staff of accountants. In response, Pecora submitted twenty-three specific requests for materials. Morgan & Company agreed to fifteen, took seven under consideration, and rejected one, a request to see the bank's articles of copartnership and distribution of profits.

Pecora would stand for no recalcitrance. Together with Senator Fletcher he prepared a new resolution to broaden his mandate to cover all phases of banking beyond the original securities objective. The resolution passed unanimously, and the Senate granted an additional $25,000 for further hearings.

Throughout April, Pecora's investigators sorted through the voluminous records at the Morgan bank on Wall Street. Davis and Pecora sparred frequently over the confidentiality of the bank's depositors and borrowers. Not quite as obliging as the National City Bank's counsel, Davis denied Pecora the right to work nights in the bank after closing hour. But by the end of May, Pecora had accumulated enough material to call J. P. Morgan, jr., as a witness.

Long lines of curiosity-seekers filled the corridors of the Senate Office Building as the Banking Committee inquiry resumed on May 23. A squad of telegraph operators stood ready to relay reporters' stories to newspapers across the country. Press photographers stationed themselves in the caucus room. All waited to see the head of the famed House of Morgan testify before Congress for the first time since 1912, when the elder J. P. Morgan faced the Pujo Committee, and many wondered if Pecora would again score as heavily as he had against Mitchell. Entering the great marble chamber, the ponderous Morgan perfectly fit his austere public image. On the stand, however, he palled in comparison with his father. Gone were the arrogant, self-assured responses with floor-thumping emphasis. Morgan, jr. was an affable, quiet-spoken witness. His voice, with its distinct British accent, fell so low that few spectators could hear him. Although he and his firm's other partners had studiously undergone Davis's coaching sessions before the hearings, Morgan still stumbled over names and events and frequently conferred with his counsel before answering.

After the sordid revelations on the National City Bank, Pecora found J. P. Morgan & Company a relatively conservative institution. Even so, he unveiled enough surprising evidence to fill headlines for the next two weeks, exposing the private dealings of a very private banker. In every instance, Morgan & Company could claim the technical legality of their policies, while Pecora could demonstrate how far they had gone to stretch their legal and ethical standards. Most shocking to the Depression-ridden public was the initial disclosure that the fabulously wealthy Morgan and his partners paid no income taxes during the years 1931 and 1932 in the United States, although Morgan had paid taxes in England during those years. This deficiency had resulted from the firm's net loss of twenty-one million dollars during 1930; and

Morgan put his office manager, Leonard Keyes, on the stand to verify the bank's substantial decline. Pecora rebutted these contentions by revealing that the bank had added a new partner two days after the New Year in 1931 in an intricate maneuver to extend their losses of 1930 for another year. "That sort of parlor magic may satisfy the courts and the moronic sycophants of big business," a columnist for *The Nation* wrote in undisguised anger, ". . . but it will neither soothe nor deceive any honest person of adult intelligence."

Bringing Morgan back to the stand on the second day, Pecora moved from taxes to stock distribution and created an even greater shock wave by disclosing a long list of dignitaries who had accepted favors from the Morgan bank. In 1929 these favors had taken the form of preferential invitations to buy stock in the Allegheny Corporation, a railroad holding company venture which the Morgan firm was handling. Since Morgan & Company generally dealt in bonds and did not sell common stock to the public, it decided to permit certain individuals to privately purchase the stock, offering it to them at twenty dollars a share, while the market value averaged thirty-five dollars a share. Invited purchasers included officials from banks, insurance companies, industry, railroads, and utilities, as well as editors, lawyers, and politicians. The names of Roosevelt's Secretary of the Treasury, William H. Woodin, Ambassador-at-Large Norman H. Davis, Senator William G. McAdoo, Charles A. Lindbergh, John W. Davis, former Vice President Charles G. Dawes, and Democratic National Chairman John J. Raskob peppered the Allegheny list. While the bank disclaimed any desires for favors in return, Pecora was able to produce an embarrassing note from Raskob, who assured the bank of his deep appreciation and sincerely hoped that "the future holds opportunities for me to reciprocate." Finding public officials from both parties on the list seriously damaged the bank's credibility. Few observers accepted it as a strictly business arrangement. Such conservative journals as the *New York Times* and *Business Week* editorially criticized the House of Morgan, while columnist Walter Lippmann denounced such practices as preferential lists as evidence "that no set of men, however honorable they may be and however good their traditions, can be trusted with so much power and the opportunity for personal gain which it carried with it."

Twenty years earlier, Brandeis had warned in *Other People's Money* that "the dominant element in our financial oligarchy is the investment banker." These bankers used their depositors' funds and their own profits from stock underwriting to move onto innumerable boards of directors, where they could heavily influence the course of American industry. In 1933, Pecora revealed that Morgan partners held 126 directorships in 89 different corporations, with total resources of nineteen billion dollars. Morgan's influence further spread through the loans his bank had made to select individuals, including many prominent bankers. "They are friends of ours, and we know that they are good, sound, straight fellows," Morgan insisted, denying any improprieties.

The banker objected most strenuously to Pecora's plans to make public J. P. Morgan & Company's articles of copartnership. These impressively engrossed parchments, hung from a metal bar with a new sheet for each partner, pinpointed Morgan as the exceedingly powerful lord of his own financial empire. Final decisions in all banking matters lay with Morgan. He approved all new partners and could fire any one of them at any time. Further, Morgan retained complete discretion over the distribution of half of the firm's annual profits. None of this information had been public knowledge. No bank examiner ever went through the bank's books. Morgan insisted that he would not have had the "slightest objection" to releasing the information, but that no one had ever asked, except for the Pujo Committee. "That investigation was the one held about twenty years ago?" Pecora asked. "That is the only public statement we have ever made about anything," Morgan responded.

On May 25, while Morgan was still on the stand, the Senate passed the Glass-Steagall banking reform bill. In the light of the Pecora inquiry, Congress had amended the bill to cut from two years to one the time in which all commercial banks, like National City, must divorce their investment affiliates, and private banks, like Morgan & Company, must abandon either their banking or investment functions. Passage of the bill also freed its sponsor, Senator Carter Glass of Virginia, to devote more time to the Wall Street hearings. Alternately ill and busy with his own bill, Glass had rarely attended the early committee meetings when Pecora had outlined the broad scope of his plans. Now, the senator insisted that the counsel should give preliminary briefings to the committee before each session. Beyond his concern for senatorial prerogatives, Glass felt personally involved in the Morgan inquiry. Two of Morgan's partners, Russell C. Leffingwell and S. Parker Gilbert, had served as Glass's assistants when he was secretary of the treasury in the Wilson Administration. Both now complained to him of the injustices in the committee's proceedings. At closed-door executive sessions Glass supported the Morgan contention that the committee should not make public such information as the preferential stock lists or the names of borrowers from the bank.

Glass's impatience finally burst into the public hearings during Pecora's examination of another Morgan-sponsored holding company, the United Corporation, and its preferential stock lists. Peevishly, the senator questioned the whole point of the hearing. Pecora responded by reading aloud the text of the resolution authorizing the hearings, but Glass remained unsatisfied. Pecora was wasting the committee's time, he argued, with highly technical questions of "no significance to a man of ordinary intelligence." Obviously irritated over Glass's heckling, Pecora described his plans to the committee, plans which had already been outlined during Glass's absence, and remarked that not a single committee member had requested further information. "I want to assure Senator Glass that the compensation of $255 a month which I am receiving for these services is no incentive to me to render these services or continue to render them," Pecora said heatedly. With these words, spectators in the chamber suddenly broke into loud and prolonged applause for the counsel, visibly startling many of the senators. "Oh yes," Glass grumbled as the cheering died down, "this is what it is all about. We are having a circus and the only thing lacking now are peanuts and colored lemonade."

Throughout these clashes, the committee's chairman, Duncan Fletcher, consistently came to Pecora's defense. A small, frail man of seventy-five, with a thin, quavering voice, Fletcher generally played a passive role in the hearings, rarely interrupting Pecora's questioning. When Senator Glass demanded a special executive session to discuss the counsel's techniques, Fletcher invited Pecora to attend and defend himself. "Our members have

been drawn around a long table for nearly a week without one particle of knowledge beforehand about what counsel for the committee proposed to disclose," Glass complained. At the session on Thursday morning, June 1, Glass proposed that counsel should not introduce any testimony that he had not already explained in advance to the committee. Senators James Couzens and Fred Steiwer, both Republicans, and Democrat Edward Costigan, all spoke out against the proposal. Pecora, at Fletcher's request, added that the proposal would destroy the investigation's effectiveness by increasing chances of premature leaks to the press. "How dare you tell this committee what to do?" Glass interrupted indignantly. If the motion passed, Pecora continued, he would resign and tell the press the reasons why. "Now you're trying to intimidate us!" Glass stood up shouting. Fletcher and the majority of the committee, however, rallied to Pecora's support and solidly defeated the Glass proposal. On their way back to the hearings, Fletcher pointedly took hold of Pecora's arm as a physical gesture of support.

Passing through the crowd of reporters at the caucus room doorway, the senators sensed from the commotion that something unusual had happened in their absence. While the committee had met in executive session, an enterprising press agent had slipped into the hearing room and placed a circus midget in the lap of an unsuspecting J. P. Morgan. Thinking at first it was a child, Morgan put his arm protectively around her. "I've got a grandson bigger than you," he said. "But I'm older," replied the midget. "She's thirty-two," the press agent informed him, and Morgan slid the little woman off his lap while press photographers clamored around taking pictures. Thoroughly angered, Chairman Fletcher denounced the incident as a discourtesy and requested that newspapers refrain from printing any photos. But the next morning pictures of Morgan with the midget in his lap spread across the nation—ironically symbolizing the congressional humbling of the once Olympian bankers.

"Public opinion unquestionably is behind me," Pecora told the press after his confrontation with Glass, "and I will bring out all the facts regardless of whence they hit." Even Glass recognized the political liability in defending Morgan, and at the next week's session he pressed for a new resolution to give Pecora more power to delve into Morgan's taxes. The Internal Revenue Service, the committee felt, had treated such prominent bankers as Mitchell and Morgan far too gently. It had spent merely one day in examining tax returns from J. P. Morgan & Company and its investment house, Drexel & Company, for 1930; and a revenue agent had approved one statement with the notation: "Returned without examination for the reason that the return was prepared in the office of J. P. Morgan and Company and it has been our experience that any schedule made by that office is correct." J. P. Morgan, however, believed that Pecora had distorted his tax situation. He reminded the committee during his final day of testimony that his firm paid heavy taxes all during the 1920s until the stock market crash. "Income taxes are, after all, paid upon income and not upon deficits," he concluded. Not all of his partners could afford such indignation. Two Morgan associates, Thomas W. Lamont and his son, Thomas S. Lamont, paid back taxes and stiff delinquency fines as a result of Pecora's disclosures.

Additional power to examine and use income tax records assured an inescapably tight legal and financial web against any witness. The great success of Pecora's investigations came primarily from his skill at collecting, analyzing, and assimilating large quantities of data concerning his witnesses' activities. With the power of subpoena, his staff would descend upon a banker or broker and go through his records, file drawer after file drawer, page by page, selecting and photostating documents. Staff lawyers and accountants would assemble this material to reconstruct the motivations, discrepancies, delinquencies, and frauds involved. They drew a multitude of charts, tracing every event and statistic. After narrowing down the documentation, they outlined the subject's transactions in chronological narrative on letter-sized sheets, with citations in the margins to specific documents which could prove each assertion. The corresponding records filled two large trunks, which Pecora entrusted to his nephew, Louis Stephens, who made sure that the appropriate item was ready at each stage of the hearings. Armed FBI agents guarded these trunks day and night.

Such a mass of documentation, covering long and obscure financial dealings, presented a formidable challenge for any attorney to keep straight during his cross-examination. Here Pecora's photographic memory amazed even his own staff. Each night he would read rapidly through the thirty- or forty-page memorandum they had prepared for the next day, stopping to question only an occasional reference. After that he would rarely refer to the memorandum again. Yet he covered the material coherently and correctly during the next day's proceedings. "I looked with astonishment," wrote John T. Flynn, "at this man who, through the intricate maze of banking syndicates, market deals, chicanery of all sorts, and in a field new to him, never forgot a name, never made an error in a figure, and never lost his temper."

Since Pecora already knew the answers he expected to elicit during testimony, and had the proof to challenge any witness who lied, he could proceed in a genial fashion, without badgering his witnesses. Politely, he would allow them to go off on their own stories until he felt they had registered a point, then he would return to his own line of questioning. He worked around the periphery of each problem. When a witness began to suspect his intentions and balked at answering, Pecora would start at another point on the periphery and work inwards from that direction, until finally his central objective became obvious to everyone. At the crucial moment in the testimony, Pecora's whole demeanor would change. Leaning forward in his chair he would rapidly recall all of the earlier admissions he had led the witness to make, pointing inexorably toward his guilt or complicity. Attuned to public relations, he also geared his questioning towards the daily press deadlines. As the hearings progressed he learned to make his most important points early at each session to ensure press attention and headlines in the afternoon papers. He saved some entirely new material for late in the day for the next morning's papers. Public dissemination of information always remained one of his fixed goals, as important as establishing corrective legislation.

Throughout the long hearings, Pecora depended heavily upon his staff and maintained a close working relationship with them. From Monday through Friday he shared a suite of rooms with them at the Mayflower Hotel, which the nearly bankrupt hotel provided at a reduced rate for them and other luminaries, in an attempt to attract more guests. At night, Pecora would return to the Mayflower, look over new material for the next day, and then relax with the staff, usually in long card-playing sessions. For the most part, the staff worked together smoothly. As the hearings wore on and pressures mounted, tensions did rise, but Pecora, an excellent raconteur, could lean back, light his cigar, and tell another long story to ease the situation. The staff of younger men called him "Chief," a moniker from his days as chief assistant D.A. He in turn called them "Boys." This paternalistic relationship brought him complete devotion from them, although he demanded the last word on all decisions and could summarily dismiss a subordinate whose loyalty he doubted.

The Congress of the New Deal's "first hundred days" recessed on June 16, 1933, but the Pecora hearings continued on into the summer. Oppressive heat and humidity, perennial afflictions of Washington summers, soon had an impact. By the end of the Morgan hearings, Fletcher had permitted gentlemen in the room to remove their jackets, J. P. Morgan dozed in his chair, and other witnesses appeared dazed and tired on the stand. Before adjourning, however, Pecora wanted to examine the second most prominent private banking house in the United States, Kuhn, Loeb & Company. Otto Kahn, senior partner in the firm, had already informed Pecora of his deep distress over the National City Bank revelations and his desire to cooperate fully with the committee to help end "improper practices." As a witness, the elderly banker, dapper and cosmopolitan, with a large handlebar mustache, condemned the "cutthroat competition of bankers in the 1920s," and he recounted tales of American bankers fighting each other for control over European and South American bonds. Kahn denounced the profit-and-loss provisions of tax laws which created artificial depressions each December when investors sold stocks to establish losses, and he called for government control of every organization that dealt with money. "I know a great deal must be changed," he admitted. "And I know the time is ripe to have it changed."

Out of deference to other members of the financial community, however, Kahn was less than candid, and reneged on his promise of complete honesty. Annoyed over Kahn's increasing hesitancy, Pecora pointed out that Kuhn, Loeb & Company had not been free from transgressions themselves. When he brought up the issue of ninety million dollars in loans that the company had arranged in Chile, Kahn winced. "You have touched on a sore spot," he admitted. "It is the only issue which my firm has made, the only foreign issue, which is in default." Kahn himself, Pecora revealed, had paid no income taxes for 1930, 1931, and 1932, although his firm reaped profits of more than twenty million dollars from pool operations between 1927 and 1931. For distributing the stocks of the Pennroad Corporation, a railroad holding company, Kuhn, Loeb & Company had earned a profit of $5,840,000, although investors in the stock had lost over $106,000,000 collectively when its price plunged in the crash. "We were all sinners," Kahn now repented. "If we indulge again in practices that are socially, economically and from the point of view of the country undesirable, I think the policeman ought to be ready to step in."

As Kahn stepped down, Pecora conceded to the heat and senatorial pressures to recess his investigation for the summer. During their vacation, he set his staff at examining the records of two other well-known banks: Dillon, Read & Company, a private bank influential in the stock markets, and the Chase National Bank, reputedly the largest commercial bank in the world.

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Concentrating first on Dillon, Read, Pecora subpoenaed its officers to testify in early October. The bank actually specialized in selling securities and did a relatively small business in accepting deposits, but Dillon, Read & Company had shown much ingenuity in raising funds from other sources.

During the "Great Bull Market" of the 1920s, Dillon, Read had pioneered in developing the highly popular investment trust. Through this device they offered average investors an opportunity to buy shares of a corporation which did nothing but invest in stocks itself. Presumably, with its experienced management and skilled analysts, the investment trust would purchase only the most sound and productive stocks available. At the height of the speculative heyday of 1929, an average of one new investment trust appeared every day. Dillon, Read exhibited particular skill in organizing such trusts and managed to maintain control over them through the use of "nonvoting" stocks. Only a small portion of the investment trust's stocks which Dillon, Read retained carried voting privileges. The far greater number of stocks earned dividends, but their holders had no say in the trust's management.

In 1924 they formed the Foreign Securities Corporation, capitalized at $30,000,000, of which Dillon, Read purchased $5,000,000 in voting stocks, enough to totally control the organization. Later that same year, they formed the even larger United States and International Securities Corporation, capitalized at $60,000,000, of which Dillon, Read purchased $10,000,000 worth of controlling voting stock. This latter ten million, however, came not from Dillon, Read, but from the earnings of the Foreign Securities Corporation. The bank had thus used its voting privileges in one investment trust to divert its surplus funds into another, rather than distribute the money as dividends to the common stock holders. Furiously, Senator James Couzens called it "rotten ethics to take $10,000,000 out of an investment trust you own, or which you control . . . and put it into another investment to further augment your own profits. I think that is reprehensible." Furthermore, Pecora noted that eleven members of Dillon, Read & Company had made almost seven million dollars in profits on the common stock of these trusts, after an initial investment of only $24,110.

Greed and excessive profits also characterized the activities of the giant Chase National Bank, as Pecora unraveled that story. Earlier that year Chase had deflected public attention by adopting his own sweeping reforms. President Winthrop Aldrich endorsed the National City Bank plan to divorce banking and investment facilities, and Chase cut loose its own Chase Securities Corporation. At the same time, Aldrich called for stronger federal laws to regulate commercial and private banking. But Pecora was less interested in Aldrich than he was in the bank's recently retired chairman, Albert H. Wiggin, known as "the most popular banker in Wall Street." Wiggin had stepped down from the bank in December 1932 after twenty-eight years of service, shortly after Chase had merged with the Rockefeller-dominated Equitable Trust Company.

Still held in high esteem on Wall Street, Wiggin was a member of fifty-nine boards of directors and served on the executive committee of the Federal Reserve Bank of New York. In fact, stockholders of Chase National Bank had little idea of the complete extent of Wiggin's popularity until the investigations disclosed how the bank's executive board had secretly granted Wiggin a

yearly retirement salary of $100,000 for life. During the last four years of his active service, the banker had also received $1,500,000 in salaries and bonuses from the bank and securities company. Wiggin protested that his associates from the bank had determined these generous emoluments. "And I helped to fix theirs," he added. "You helped to fix theirs and they helped to fix yours?" Pecora asked incredulously. "Yes," said Wiggin, "we all sat together." As a result of the hearings, an intensely negative reaction from Chase stockholders forced Wiggin to relinquish his $100,000 annual salary.

Unlike many of his predecessors on the stand, Wiggin had dutifully paid his income taxes throughout the panic and Depression. Indeed, Pecora found it interesting that Wiggin and his family paid $4,625,000 in taxes from 1928 to 1932, surprisingly excessive even considering Chase's bonus system. This evidence led Pecora into an examination of three Wiggin family corporations, the Shermar, Murlyn, and Clingston, named for Wiggin's daughters and their husbands, and three other family corporations in Canada. He discovered, as he had anticipated, that the banker had used these corporations for speculative purposes, engaging in a number of pool operations. But even Pecora had not suspected the chairman of the Chase National Bank of speculating in his own bank's stocks. From 1927 until 1931 the Chase Securities Corporation, with Wiggin's full knowledge, had manipulated Chase stocks by purchasing and selling over $860,000,000 in shares to exercise a "steadying effect" on its market value. Despite these efforts, the stock had fallen from a high of 575 in 1927 to 17⅞ in 1933. During these same years the Wiggin corporations realized a net profit of $10,425,000, largely by selling short the bank's stocks.

Wiggin admitted his transgressions in a quiet voice, in short, simple answers, without the lengthy attempts at explanations that had so ensnarled other bankers on the stand. He made no attempt to accept personal blame for any actions, but attributed the banking abuses of the 1920s to simply "the time." During one discussion of pool operations, Pecora inquired: "Is that not a scheme for 'churning the market' and producing an activity that would stimulate prices?" "I think the market was a 'God-given' market," Wiggin replied. "Are you sure of the source?" one committee member interrupted.

In the audience, Chase President Winthrop Aldrich sat mortified over Wiggin's confessions. When Wiggin concluded his testimony, Aldrich stepped forward and asked permission to address the committee. "As long as I have anything to do with the management, the market in Chase stocks shall not be affected by the operation of trading accounts by affiliates of the bank," he swore. Later Aldrich approached Pecora privately. He had learned more about the operations of the Chase Bank during Pecora's interrogation, he admitted, than during his four years as the bank's president. The record of Wiggin's transactions, the *New York Times* bemoaned, "brought astonishment and pain to all his friends and former admirers. But this personal consequence is as nothing compared to the great shock to public confidence in our banking system."

On Wall Street, feelings ran contrary to these fears. Bankers and brokers at the securities exchanges questioned Pecora's purposes and his tactics. Although they had reached a consensus that some form of federal regulation would undoubtedly follow the investigation, many asked how the exposure of individual bankers' indiscretions could produce legislation for the stock markets. Some members of the Banking Committee agreed and anxiously counseled that the hearings return to a focus on stock manipulation. Pecora, too, was ready to shift emphasis. He had used the banking probe to examine banks' roles in stock distribution, syndicates, and the granting of loans for buying stocks on margin. Having boldly publicized the machinations of Mitchell, Morgan, and Wiggin, he turned his attention to the manipulative practices of brokers and floor traders at the mammoth New York Stock Exchange.

In this pursuit, Pecora had plenty of company. The Roosevelt Administration considered stock exchange reform among its first priorities. Because of his experiences with the Pujo Committee, the assignment for drafting an exchange reform bill fell to seventy-five-year-old Samuel Untermyer. Unfortunately, Untermyer devoted himself less to the bill than to his dream of returning to the spotlight as chief counsel for the Banking Committee. Months earlier he had rejected Senator Norbeck's pleas to accept the post under the then valid assumption that the original resolution granted insufficient powers for a complete investigation. Since then, Pecora had won new powers and considerable glory, and Untermyer realized his error. As a result of his preoccupation, he submitted a bill rehashing his earlier proposals that the Post Office Department regulate stock exchanges through control of their use of the mails. Roosevelt's advisors scoffed at this idea; it was twenty years out of date.

To ease Untermyer's disappointment, Roosevelt divided the responsibilities of the job in half. He granted Untermyer another year to devise a new exchange regulation formula, and he assigned former Federal Trade Commissioner Huston Thompson to prepare legislation for the more immediate problem of preventing fraudulent stock sales. The Senate Banking Committee, busy with the Glass bill and the Morgan inquiry, readily accepted Thompson's draft for securities regulation. But the House Interstate and Foreign Commerce Committee, under Chairman Sam Rayburn, found his version hopelessly inadequate and secured a more sophisticated bill from three young proteges of Felix Frankfurter: Thomas Corcoran, Benjamin Cohen, and James Landis. At the joint Senate-House conference committee, the wily Rayburn outmaneuvered Senator Fletcher to win adoption of the House bill. Since the Securities Act of 1933 contained no provisions for general exchange regulation, Pecora was determined to impress the findings of his investigation more fully upon the eventual exchange bill.

During the summer recess, Pecora informed Chairman Fletcher of his planned study of the New York Stock Exchange to see "the way the wheels turn around." Unexpectedly, the market mechanism gave him a spectacular show in mid-July when the "New Deal Market," a brief boom that had followed the creation of the NRA, suddenly burst. In one week thirty million shares changed hands in a downward spiral sickeningly reminiscent of 1929. Dragging the market down were the "wet" stocks of breweries and other post-Prohibition businesses that had soared in anticipation of final ratification of the Twenty-First Amendment. The pattern of short selling accompanying the decline convinced Pecora that manipulative pools were at work. Staff investigator John T. Flynn charged in his regular *New Republic* column that many of the stocks had obviously been "rigged." Commercial solvents stood at 16½ in May 1933, but during nineteen days in July almost all of its two and a half million shares were traded, running the price up to 57⅛. Just as abruptly, the pool behind it unloaded the stock, which then slid to 36. Similarly, a pool had pushed National Distiller's Products up from 9 in May to 124⅜ in July. During the week of July 17 the stock plunged 68 points.

Keenly interested in these developments, Pecora called upon President Richard Whitney of the New York Stock Exchange. Despite Whitney's assurances that the exchange would carefully investigate all pool operations, Pecora doubted the effectiveness or sincerity of exchange self-regulation. He intended to pursue public hearings on exchange practices, but found he faced an entirely different situation than with the banks. Rather than a single organization with a single set of books, the exchange actually performed as a trading post for thousands of brokers dealing with millions of corporate stocks. Finding it impossible to subpoena all these records, Pecora chose the method of a questionnaire centered on pool activities for the exchange and all of its members.

On September 30, 1933, Pecora sent two of his staff members, young David Schenker and the more experienced John T. Flynn, to present Whitney with the questionnaires. Whitney immediately recognized Flynn, whom he loathed for his caustic books and anti-Wall Street columns. Flushed with anger, the stock exchange president rushed from the room to compose himself before he could begin any conversation with them. When he returned, the two men requested that the exchange distribute their questionnaires. "You gentlemen are making a great mistake," Whitney said of their investigation. "The Exchange is a perfect institution." Two weeks later, he wrote to Pecora rejecting the request to send out the questionnaires. The cost of time and accountants to prepare answers would run into the millions of dollars, Whitney complained, and he did not feel he had the authority to make exchange members comply.

Pecora responded by subpoenaing records from the most active floor traders on the exchange. With this information, and the advice of the commission houses' brokers who generally opposed Whitney's domination of the exchange, Pecora fashioned a new questionnaire which he sent directly to the 1,375 exchange members, and a special questionnaire for the exchange itself. It then took months for the recipients to complete and return these questionnaires, and for Pecora's staff to wade through the accumulated data.

In the interim, the Banking Committee's hearings continued at a hectic pace and with a wide variety of witnesses. John J. Raskob appeared again to explain a large speculative loan that he and former Governor Alfred E. Smith had received from the Chase National Bank. Reconstruction Finance Corporation chief Jesse H. Jones testified on loans his agency had made to Texas banks with which he was associated. Harry Sinclair of Teapot Dome fame came under subpoena to discuss syndicate dealings in Sinclair Oil stock. The seeming unwieldiness of the hearings caused some dissension. "Pecora was like a police chief who rounds up all the suspicious characters in town to solve a jewel robbery," presidential-advisor Raymond Moley sniffed. But Pecora also bore much pressure not to miss any opportunities to expose financial ills. Banking Committee members each had areas of special concern they urged upon him. Michigan Senator James Couzens directed him towards the Detroit bank crisis. Ohio Senator Robert Bulkley was interested in the Cleveland bank situation. New Jersey Senator Hamilton Kean asked for an investigation of short selling in airline stocks. Eventually the long length and diversification of the hearings began to weigh upon their effectiveness. The three-ring atmosphere of New Deal Washington came to dwarf Pecora's side show. His additional evidence disappeared into the financial pages, and only occasionally could he grab new headlines. Senator Fletcher finally concluded that the hearings had lasted long enough. He asked for completion by January 1, 1934, in time for the committee to draft legislative recommendations.

Competition from other quarters also hastened the committee's concern for a stock exchange bill. Although Untermyer had made little progress with his bill, a special committee under the chairmanship of Assistant Secretary of Commerce John Dickinson was also examining stock exchange regulation. Roosevelt had appointed the Dickinson Committee in response to both the July market crash and the growing hostility on Wall Street to the strict Securities Act. Characteristically, the President had filled the committee with a mixture of liberal reformers and arch-conservatives. As a result, they had produced a blandly moderate report. Racing against the Dickinson Committee, one of Pecora's staff investigators, Max Lowenthal, approached Securities Act drafters Corcoran, Cohen, and Landis and asked them to assist in preparing an exchange bill for the Banking Committee. Lowenthal, like the three young men, was a representative of Felix Frankfurter's large contingency of former law students working in the New Deal, and he knew he could count on their help. Landis, then an FTC commissioner, sent two young aides, I. N. P. Stokes and Telford Taylor, to draft the initial versions of the bill. Cohen and Corcoran revised their draft, working nights, weekends, and vacations, while holding other government positions. By January when the Dickinson report went to the White House and when Senator Fletcher was ready to ask Pecora for a bill, they had almost finished.

Fletcher's request caught Pecora in the middle of his investigation into the complicated Detroit banking collapse. Unwilling to break off the hearings, he accepted the Cohen and Corcoran draft and assigned several of his aides, including Schenker, Saperstein, Meehan, Lowenthal, and Flynn to help shape the bill into final form. After so many months of delving into Wall Street malpractice, these staff members found the Cohen-Corcoran draft far too lenient to suit their tastes. Rather than grant broad discretionary powers to any regulatory agency, they wanted the bill to specifically prohibit all forms of stock manipulation, such as short selling, pools, and wash sales. Furthermore, they insisted that the bill forbid brokers from buying and selling for their own accounts at the same time they transacted business for their clients. To prevent conflict of interest, they wanted brokers to choose either one function or the other, but not to practice both. John Flynn, who passionately distrusted all bankers and brokers, warned that any vague sections in the bill would permit shrewd Wall Street lawyers to circumvent its basic intent. Flynn's strong arguments accounted for much of the stringency in the final draft. Both Cohen and Corcoran recognized they were working for Pecora and must adhere to the wishes of his staff. In a final forty-eight hour session of continuous work, the combined group produced a bill which Pecora could wholeheartedly endorse.

As the legislative process took up the exchange bill, Pecora's role diminished. He concluded his investigations into the Detroit and Cleveland banking structures as the Senate Banking Committee prepared to open hearings on the bill. The whole focus of committee procedures shifted, with the center of attention moving from the counsel as prosecutor questioning unsuspecting witnesses to the witnesses as advocates, arriving with prepared speeches for or against the bill. Where the senators had previously permitted Pecora to conduct the questioning relatively unhindered, they now took the lead in quizzing the witnesses themselves. When Thomas Corcoran appeared to defend the exchange bill, the committee even permitted Roland Redmond, counsel for the New York Stock Exchange, to cross-examine him. Pecora fell increasingly into the background.

The New York Stock Exchange and its allies conducted a bitter lobbying and publicity campaign against the bill, convincing many congressmen of the need for compromises in the stern first draft. Whitney testified that the bill, by tampering with margin trading, might disrupt the nation's credit system, that its requirements for regular financial reports would be "absolutely prohibitive," and that it might drive stocks and investors to foreign exchanges. Instead, he proposed a program of exchange self-regulation through participation on a federal regulatory panel, similar to the Dickinson Committee recommendations. Conservative opposition in Congress, small but intense, followed this line. Republican representatives also attacked Cohen and Corcoran personally as the boys from "the little red house in Georgetown" who had prepared the bill to "Russianize everything worthwhile."

By the time the conference committee met to settle differences between House and Senate versions of the exchange bill, the original draft had undergone serious revision. The congressmen had reduced margin requirements and made them more flexible, authorized a new Securities and Exchange Commission, and delegated to it powers to oversee the activities of the nation's stock exchanges. Congress also avoided prohibiting several controversial practices and, instead, authorized the SEC to carry out further studies on segregation of broker-dealer functions, regulation of the vast "over-the-counter" market of unlisted securities, and revising exchange rules for more self-regulation. After it passed overwhelmingly in both houses, Cohen and Corcoran found genuine pleasure with the compromise bill. Both suspected that they would never have gained so much if the original draft had not been so demanding. But many of the Pecora staffers were bitterly disappointed with the enacted law. They especially blamed Treasury Department and Federal Reserve Board conservatives for weakening the measure and scorned the President for not endorsing their draft more vigorously. "One word from Franklin D. Roosevelt, and the dramatic first bill would have been passed with a whoop," Flynn concluded in disgust.

Passage of the Securities and Exchange Act of 1934 brought the Pecora investigations to a close, an event not entirely satisfying to the chief counsel. He still had numerous topics left which he had hoped to cover. Max Lowenthal and others begged him to reconsider demobilizing his staff and reminded him of the work remaining. Pecora himself had hoped to conduct an extensive survey into the abuses of protective committees which reorganized bankrupt corporations. But time had run out. Many of these unfinished examinations became the responsibility of the new SEC, including the protective committee study which two young Yale faculty members, William O. Douglas and Abe Fortas, ably conducted for the agency.

In his final report, drawn from the twenty-two volumes of committee transcripts and still unused evidence, Pecora strongly indicated the need for further study and additional legislation. The Glass-Steagall Banking Act, for instance, had made a first step in detaching investment houses from the powerful banks, but too often these divisions were more real on paper than in practice. J. P. Morgan & Company gave up its securities business to the newly created firm of Morgan, Stanley & Company, and Morgan placed his son Henry in charge of this "independent" house. Brown Brothers, Harriman & Company continued as a commercial bank, while it created Brown, Harriman & Company to assume its investment business. W. Averell Harriman and his family remained as major stockholders in both. The income tax laws also needed revision. Attorney General Homer Cummings was already conducting further investigations into tax evasions on the part of bankers and brokers, even delving into the tax returns of former Treasury Secretary Andrew Mellon. Pecora was especially pleased to note that the Internal Revenue Service had recovered several million dollars in back taxes as a result of the hearings, far more than the $225,000 which the investigation had cost the government.

Whatever Pecora's admiration for the frugality of the hearings, their low budget had placed serious financial burdens upon him. He had dropped his own private law practice and felt uneasy about resuming it. Fundamentally, he could not envision serving as counsel for the banking and brokerage houses he had so recently exposed, and yet he knew the pressures he would feel to take their cases. Nor had the meager $255-a-month salary he collected during the hearings helped his financial independence. When the hearings came to a close, the Banking Committee met in executive session with Pecora to discuss that very question. His persistent nemesis, Carter Glass, introduced a resolution to compensate Pecora for the true worth of his time and energy. Glass proposed that the Senate pass a special appropriation of not less than $125,000 for his services, "a drop in the bucket" compared with the retainers of the Wall Street lawyers appearing in adversary during the hearings. The full committee unanimously approved Glass's resolution, but Pecora asked them not to pass it. He had acted strictly out of public service, he explained. Furthermore, having received an outpouring of mail from across the country commending him for working on a small salary, he could not accept such a large reward now.

His refusal was altruistic, but Pecora also had political ambitions. In October 1933, for example, he had acquiesced to the urgings of James Farley and President Roosevelt to accept the reform Democratic nomination for New York district attorney, although he could campaign only on weekends so as not to interrupt his hearings. In the LaGuardia fusion sweep in that municipal election, Pecora lost badly. Many observers, however, felt that the President owed him a favor. Pecora dropped a hint to that effect at the White House ceremony when Roosevelt signed the Securities and Exchange Act. "Ferd, now that I have signed this bill and it has become law, what kind of a law will it be?" the President asked as he handed him one of the pens. "It will be a good bill or a bad bill, Mr. President," Pecora replied, "depending upon the men who administer it." Afterwards, Pecora let it become widely known in Washington that he expected the chairmanship of the new SEC.

It came as a definite shock to Pecora, therefore, when Roosevelt nominated him for a one-year post on the commission and gave the five-year post, with his implicit approval for chairman, to financier Joseph P. Kennedy. Only a few months earlier, Pecora had uncovered Kennedy's name as a participant in a pool of Libby-Owens-Ford Glass Company stocks during the July crash. Neither he nor his staff could believe that such a stock market operator could lead the commission they had helped create. "I did not in my wildest dreams imagine he would appoint a speculator as chairman of that body," John T. Flynn exclaimed. "I say it isn't true. It is impossible. It could not happen." Pecora thought first of refusing the appointment, but then he appeared for the swearing-in ceremony and delayed it for two hours while he privately negotiated with Kennedy over commission policies and personnel. Several of his assistants from the hearings, including Saperstein, Schenker, and Stephens, eventually followed him to the SEC. But after so long in the spotlight as the leader of the hearings, Pecora could not adjust to the bureaucratic routines of the new regulatory commissions. Within six months he resigned the post to take a seat on the New York Supreme Court, where he remained for the rest of his career, with the exception of an unsuccessful campaign for mayor of New York in 1950.

Nor were the years of aftermath totally rewarding for other participants in the Pecora hearings. Albert Wiggin returned to his retirement still wealthy, but with his reputation shattered. J. P. Morgan left the Pecora hearings only to face more congressional scrutiny before the Nye Committee. Increasingly, Morgan withdrew from his banking firm and spent his last ten years as far away from press photographers as he could. In 1940 the Morgan bank finally incorporated, and in 1942 it joined the Federal Reserve System, ending its aloof and private status. Richard Whitney, the aristocratic president of the New York Stock Exchange, lost his position with the help of new SEC-sponsored exchange rules. In 1938 he confessed to insolvency and admitted to embezzling funds entrusted to his investment company. As his property went on the auction block to pay his debts, Whitney left for imprisonment at Sing Sing. Of all the discredited witnesses, Charles E. Mitchell emerged the most honorably in later years. In 1938 the Supreme Court ruled he owed the government $1,100,000 in taxes and penalties. Refusing to declare bankruptcy because it was not the "square" thing to do, Mitchell worked for years to repay his taxes and debts.

The Pecora investigations and the creation of the Securities and Exchange Commission profoundly affected Wall Street. They transformed the New York Stock Exchange from an almost private club into a semi-public institution, and they made the federal government responsible for overseeing nationally vital banking and brokerage activities. The flagrant financial abuses that characterized the 1920s became less pronounced, although they did not disappear. Five years later, while writing his memoirs of the hearings, *Wall Street Under Oath*, Pecora predicted possible regression. "These laws are no panacea, nor are they self-executing," he warned. "More than ever we must maintain our vigilance. If we do not, Wall Street may yet prove to be not unlike that land, of which it has been said that no country is easier to overrun or harder to subdue."

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THE LEGISLATIVE IMPACT OF THE PECORA INVESTIGATION

by

Donald A. Ritchie

"Nothing is so easy as to start a congressional investigation," wrote the Washington correspondent for the *Baltimore Sun* in 1927. "A resolution, a brief but violent speech, a few newspaper interviews—and the game is on." Reporter J. Frederick Essary saw "the game" repeated often enough to become cynical about the process. After the fanfare had run its course, the investigations generally died quiet and obscure deaths, often without filing reports, and rarely with any attempt to produce legislation. Looking back on the major investigations he covered during his career, Essary concluded: "There were no results in terms of legislation. They were simply a series of parliamentary mockeries, at best; a species of polite fraud, at worst."[1]

Seven years after Essary's scathing comments, the Senate Banking and Currency Committee submitted the final report of its two year investigation into banking and stock exchange malpractice. Justifiably, the report assumed a tone of self-congratulation, for the committee's accomplishments helped dispel much of the prevailing low opinion of congressional investigations. Under the direction of its chief counsel, Ferdinand Pecora, the committee exposed the market manipulations of some of Wall Street's most prominent leaders. Pecora's performance ranked among the finest in congressional history. His inquiries were well prepared; he treated witnesses sternly but fairly, basing his accusations on thoroughly documented evidence; his questions led to startling admissions of guilt and complicity; most significantly, his hearings produced a long list of corrective legislation.[2] "During the process of this investigation," the final report noted, "Congress enacted the Banking Act of 1933, the Securities Act of 1933, the Securities Exchange Act of 1934, and several amendments to the revenue act calculated to eliminate methods of tax avoidance . . . ." Recognizing the Pecora probe as a "principal procreator of statutes," scholars frequently cited it among the shining examples of congressional investigations.[3]

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[1] J. Frederick Essary, *Covering Washington: Government Reflected to the Public in the Press, 1822-1926* (Boston, 1927), 212-13.

Although Pecora excelled in the conduct of the investigation, he was unable to exert direct control over its legislative outcome. The complexity of the hearings, the pressure of time, and the competition of a number of other groups stole much of the initiative and responsibility for the New Deal's banking and securities legislation, and forced Pecora into many unsatisfactory compromises. Banking Committee members, who gave their chief counsel free rein over the investigation resumed their traditional roles in shaping the final bills, demonstrating the limited ability of a staff member, no matter how able, to steer the legislative process. While Pecora and his staff intensely favored tougher federal regulation of the securities and exchange system, their impact was more in the climate they set then the legislation they produced.

Pecora entered the securities debate at a relatively late date. Public distrust of stock market operations had grown out of the agrarian movement of the late nineteenth century, when farmers accused commodity speculators of unfairly affecting their prices. During the Progressive Era, urban reformers shifted attention to the "bucket shops" and other forms of stock swindling.[4] The panic of 1907 raised further questions about the power of the private investment houses and the growth of a "Money Trust." In 1912, the Pujo investigation delved into those issues and recommended federal regulation of the exchanges, clearing houses, and national banks, and full disclosure of all information relating to stock sales. But none of those proposals became law, and the federal government steadfastly refused to act. On the state level, some reform-minded legislatures enacted "blue sky laws" (intended to prevent unscrupulous stock salesmen from selling everything including the blue sky above), permitting the state to assay the value of securities before their sale.[5]

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[2] For the general background of the Pecora hearings, its witnesses and major issues, see Donald A. Ritchie, "The Pecora Wall Street Expose, 1934," in *Congress Investigates: A Documented History, 1792-1974*, ed. by Arthur M. Schlesinger, Jr. and Roger Bruns (5 vols., New York, 1975), IV, 2555-732. Ferdinand Pecora wrote his own version of the investigation: *Wall Street Under Oath: The Story of Our Modern Money Changers* (New York, 1939).

[3] U.S. Congress, Senate, Committee on Banking and Currency, *Stock Exchange Practices*, S. Rept. 1455, 73rd Cong., 2nd sess., 6 June 1934, 4; M. Nelson McGeary, *The Development of Congressional Investigative Power* (New York, 1940), 86, 115.

[4] *"Bucket shops" were generally small-time fraud operations in which the "brokers" gambled that their clients had misjudged the market, and delayed buying or selling the clients' stock long enough to make a profit for themselves. Brokers who lost the gamble simply closed up shop and moved elsewhere.*

[5] Cedric B. Cowing, *Populists, Plungers and Progressives: A Social History of Stock and Commodity Speculation, 1890-1936* (Princeton, 1965), 3-74.

During the 1920s, "voluntarism" became the catchword on Wall Street and in Washington. Both the Investment Bankers Association and the New York Stock Exchange talked impressively about self-regulation, but the speculative mania of that decade demonstrated their ineffectiveness. By early 1929, when Herbert Hoover reached the White House, he expressed uneasiness over the laxity of rules governing stock transactions, and launched a campaign to convince Wall Street bankers and exchange leaders to tighten their own regulations. Although he admitted that his efforts were to no avail, Hoover stopped short of proposing a concrete program of federal action. "To ask Congress for power to interfere in the stock market was futile," he decided and, in any case, he considered such action unconstitutional. Still, rumors that "bear raiding" Democratic speculators were sabotaging his recovery program haunted the president. In February 1932, he called on Congress to investigate the charges. The revelations that followed, Hoover later wrote, "exposed a rottenness far worse than I had anticipated."[6]

Commenced with much publicity, the Banking Committee hearings quickly became an embarrassement to the administration and the Senate. The committee's inept counsel proved unable to produce the hoped-for expose of "bear raiding." Chairman Peter Norbeck received a thousand applications for the post of counsel, but the meagre $255 per month salary, and the narrow nature of the investigation, tended to discourage qualified and experienced lawyers from applying. When the chairman solicited others for the job, men of the stature of Harold Ickes, they turned him down. On the witness stand, New York Stock Exchange President Richard Whitney, Democratic National Chairman John J. Raskob, and other Wall Street figures easily deflected the inquiries into their business affairs. After a few months the Hoover administration lost interest and disheartened committee members talked of calling a halt to the investigation. At the end of the year, Chairman Norbeck confided to friends: "I am having a dickens of a time here to get my Wall Street investigation started. There is so much 'inertia'; I find it in the most unexpected places, even among those from whom I expected much help."[7]

In November 1932, the Democrats won a majority of seats in the Senate and, during the long "lame duck" session, it was unclear whether they would continue the investigation. Democratic Senator Burton K. Wheeler of Montana had gone on record as urging the Banking Committee to "go to the bottom of the stock market debacle, not so much with the idea of sending somebody to the penitentiary, but with the idea of passing legislation to prevent this thing occurring in the future." But more conservative Democrats, led by Virginia's Carter Glass, worried that the proceedings would undermine public confidence in the faltering markets. At this point two events saved the investigation from collapse: the hiring of the little-known Ferdinand Pecora as chief counsel, and the elevation of Senator Duncan U. Fletcher to the chairmanship of the Committee on Banking and Currency.[8]

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[6] Michael E. Parrish, *Securities Regulation and the New Deal* (New Haven, 1970), 21-41; Herbert Hoover, *Memoirs: The Great Depression, 1929-1941* (New York, 1952), 16-20, 125-31. "Bears" thrived on declining stock markets. They offered to sell stocks they did not own, at high prices, and then waited for the market to fall before purchasing sufficient shares to cover their sales. If the market did not decline naturally, some bears used erratic buying and selling tactics to frighten other investors into panic selling, thus creating the "bear raid."

[7] Gilbert C. Fite, *Peter Norbeck: Prairie Statesman* (Columbia, Mo., 1948), 168-83.

Outgoing Chairman Norbeck gave the assignment to Pecora late in January 1933, with the understanding that he would serve only until the end of the session in March. With just a few weeks in which to work, Pecora assembled a staff of lawyers from the New York District Attorney's office (where he had been chief assistant district attorney), and several accountants and Wall Street financial specialists. Recognizing that his predecessor had failed largely for the lack of hard evidence, Pecora avoided going into public session and spent most of his preciously few days deep in research. As his target, he chose the National City Bank and its investment firm, the National City Company. He subpoenaed their books for the five years before the 1929 market crash. "The contents were very informative," said Pecora with understatement. On February 21, he opened public hearings on the National City Bank, and for the rest of the week captured newspaper headlines with sordid tales of tax evasion, misuse of bank funds, and irresponsible handling of investors. By the week's end, the bank's distinguished president, Charles E. Mitchell, had resigned in disgrace. Senator Fletcher introduced a resolution to continue the probe into the next Congress with the endorsement of the president elect, Franklin D. Roosevelt.[9]

The new chairman was a boon to the investigation. A seventy-five year old Florida Democrat, Fletcher had a long record of progressivism. He came to the Senate in 1909, after a campaign in which he attacked "rascals in Wall Street" who "soaked millions of dollars out of the South." A supporter of Woodrow Wilson's New Freedom, Fletcher was one of a handful of senators whose congressional service dated back to the Pujo hearings. The elderly chairman, who was in poor health, gave considerable independence to his chief counsel, and permitted him to call witnesses and conduct examinations without advance consultation with the committee members. The chairman and chief counsel made an unusual team, the old man with round, ruddy face, neat mustache, and fringe of white hair, and the "swarthy man with protuberant jaw." One reporter suggested that "some painter should have perpetuated the combined scene of masters of finance, with Senator Fletcher sitting there apparently dozing, Pecora pointing eternally with his cigar at the assembled giants of money."[10]

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[8] *The New York Times*, 8 June 1932, 1; 25 January 1933.

[9] Columbia University Oral History Collection, Nicholas Murray Butler Library, Ferdinand Pecora Interviews, 655-82; *The New York Times*, 7, 26, 28 February 1933.

[10] Wayne Flynt, *Duncan Upshaw Fletcher: Dixie's Reluctant Progressive* (Tallahassee, 1971); Thomas L. Stokes, *Chip Off My Shoulder* (Princeton, 1940), 366-67.

The intense publicity surrounding Pecora's hearings reached its peak when he called the head of the House of Morgan to the stand. Although dealing largely with technical financial material, Pecora made sure there was news for the press which the average citizen could understand, including income tax evasion, preferential stock distribution, and other financial favors that suggested the misuse of power and public trust. The mystique of the house of Morgan, where no bank examiner had ever dared to venture, made J.P. Morgan, Jr. the investigation's star witness. Newspaper reporters and photographers crowded the ornate Senate Caucus Room to glimpse Morgan, creating an almost carnival atmosphere. One Scripps-Howard reporter, anxious for a story to meet his deadline, smuggled into the committee hearing a Ringling Brothers and Barnum & Bailey Circus midget and her press agent. During a brief recess, the press agent slipped the little woman into Morgan's lap and the photographers eagerly recorded the scene. The next morning, front-page photos of the once awesome banker cradling a midget provided the investigation's ultimate symbol of its humbling of Wall Street.[11]

It was during the Morgan inquiry that the investigation first made itself felt on major legislation, specifically the Glass-Steagall Banking Act and the Securities Act of 1933. In both cases, however, its influence was only indirect. Few observers gave the Glass-Steagall bill much chance of passage during the special session of Congress in the spring of 1933. After completion of the emergency Banking Act, which reopened the nation's banks and helped restore public confidence in the banking system, neither the president nor Congress showed any interest in supporting new banking legislation. Over a year earlier, Senator Glass introduced legislation for a number of reforms including the separation of commercial banks from their securities houses but, in the face of determined opposition from the Hoover administration, the bill failed. In the House of Representatives, Alabama Democrat Henry Steagall introduced corresponding legislation, but Steagall advocated federal deposit insurance, which Glass opposed, and the two remained poles apart. Michigan Senator Arthur Vandenberg tacked onto the bill an amendment for immediate deposit insurance of all accounts up to $2500. President Roosevelt told Glass flatly that he would veto the legislation if the Vandenberg amendment remainded attached.[12]

By June in a dramatic turnabout, Glass and Steagall reached a compromise which included both deposit insurance and separation of commercial and investment banking. Both houses of Congress passed the bill and President Roosevelt signed it, despite inclusion of the Vandenberg amendment. The daily revelations of the Morgan inquiry so outraged the public that Congress could not adjourn without addressing the problem, nor could the president veto the bill, no matter how much it displeased him. Pecora's documenting of the abusive relationship between the National City Bank and its investment firm not only caused those two organizations to sever their ties, but spurred Congress to reduce, from two years to one, the time alloted for other commercial banks to rid themselves of their securities houses. Thus Senator Glass, Pecora's most vocal critic on the Banking Committee, was the first to benefit from the information and publicity that he gathered.[13]

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[11] The relentless publicity following the incident so distressed the midget, Lia Schwartz (known professionally as Lya Graf) that she eventually left the United States and returned to her German homeland. There the Nazis arrested her as a "useless person" and sent her to die in the gas chambers at Auschwitz. *The New York Times*, 26 May 1963.

[12] Lawrence H. Chamberlain, *The President, Congress and Legislation* (New York, 1946), 324-36; Susan Estabrook Kennedy, *The Banking Crisis of 1933* (Lexington, Ky., 1973), 50-53, 202-23.

Unlike the drive for the Glass-Steagall legislation, the initiative for the securities bill came from the White House. Franklin Roosevelt included securities and exchange regulation as part of his "must" legislation of the "First Hundred Days." The president first assigned the drafting of the legislation to Samuel Untermyer, onetime counsel to the Pujo investigation. But the aging Untermyer could produce nothing better than a twenty year old proposal for Post Office supervision of stock and bond sales. Without removing Untermyer, the dissatisfied president turned the task over to Huston Thompson, former Federal Trade Commission chairman and author of the 1932 Democratic plank on securities reform. The new assignment, Roosevelt hoped, also would help heal Thompson's wounds—he was passed over for Attorney General. The competition annoyed Untermyer, but the president casually waved away his objections and denied that any real conflict existed. He instructed Untermyer to keep working on regulation of the stock exchanges, while Thompson wrote a bill to prevent the fraudulent sale of stocks. Within a month, Thompson produced a draft for a securities bill. Lifted out of Louis Brandeis's 1914 tract, *Other People's Money*, the bill proposed registration of information about all stock sales with the Federal Trade Commission. From the various state "blue sky laws," Thompson drew the concept of empowering the FTC to revoke the registration of stocks by those companies found to be "in unsound condition or insolvent."[14]

The Roosevelt administration believed that Thompson's bill would receive most favorable treatment in the Senate Judiciary committee, but Senator Fletcher insisted that the bill was a financial, rather than a judicial matter. The Banking and Currency Committee, said its chairman, intended to produce "well-considered legislation covering the whole subject we are now investigating, including the handling of securities." In view of the diligent work the committee had put into its investigation, Fletcher testily added, "the Senate either ought to dismiss us entirely . . . or else we ought to go and finish this very subject." Majority Leader Joseph Robinson of Arkansas agreed, and moved to

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[13] Helen M. Burns, *The American Banking Community and the New Deal Banking Reforms, 1933-1935* (Westport, Conn., 1974), 181.

[14] Huston Thompson, "Diary," 13, 19 March 1933; Thompson to Franklin D. Roosevelt, 4, 11 June, 7 July 1932, Library of Congress, Huston Thompson Papers; Raymond Moley, *After Seven Years: A Political Analysis of the New Deal* (New York, 1939), 175-79.

refer the bill to the Banking Committee. Once having overcome that slight, Fletcher and Pecora turned their attentions back to the Morgan hearings, and left the securities bill in Huston Thompson's hands. A month later, the committee approved Thompson's draft with minor revisions and sent it to the Senate. Counsel Pecora strongly endorsed its passage: "Unless we adopt new rules and enforce them," he warned, "we shall not have learned the lesson that the depression of the last three years has taught us." On May 8, the Senate passed the bill without a record vote.[15]

Because of the Pecora investigation, most national press attention focused on the Senate. Almost unnoticed were the actions of the House, which passed an entirely different securities bill. When Thompson appeared before the House Interstate and Foreign Commerce Committee, to defend the Senate bill, he came under fire from both Democratic and Republican members, who found glaring loopholes, misuse of words, and vague concepts in the draft. Most disturbing was the bill's "revocation" policy, which seemed directly contradictory to the president's securities message. Chairman Sam Rayburn appealed to presidential aide Raymond Moley, who agreed that Thompson's draft was "a hopeless and unintelligible confection." Moley telephoned Professor Felix Frankfurter, and asked him to come down from the Harvard Law School for a weekend to assist the House committee in rewriting the bill.[16]

At the Carlton Hotel, just one floor beneath the suite of J.P. Morgan, Jr., Frankfurter assembled three of his brightest proteges, Benjamin V. Cohen, Thomas C. Corcoran, and James M. Landis, and instructed them to write a new bill. There was not much of Thompson's draft they considered worth saving ("Oh! it was a terrible piece of legislation, as it was handled in the Senate," Landis later remarked). Like the president, they believed it unwise for for the federal government to judge the soundness of corporations, and thought it sufficient to require publication of complete and accurate financial information about the stocks, which would allow interested parties to judge the risks for themselves. To insure truthfulness, they inserted tough criminal penalties for all involved in preparing a fraudulent stock registration, from the company's board of directors to its underwriters, accountants, appraisers, and lawyers. By Monday morning they completed their draft and had breakfast with Thompson to assure him they were "simply perfecting amendments" to his bill. Typically, FDR never bothered to tell Thompson he had replaced him, and merely shifted him to another assignment.[17]

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[15] U.S. Congress, Senate, *Congressional Record*, 73 Cong., 1 sess., vol. 77, pt. 3, 3018-20; *The New York Times*, 28 April, 9 May 1933.

[16] U.S. Congress, House, Committee on Interstate and Foreign Commerce, *Hearings on Federal Securities Act*, 73 Cong., 1 sess., 31 March 1933, 9-69, 137-38; Raymond Moley, *The First New Deal* (New York, 1966), 312.

[17] James M. Landis, "The Legislative History of the Securities Act of 1933," *George Washington Law Review*, XXVIII (October 1959), 30-36; Columbia University Oral History Collection, James M. Landis Interviews, 156-58; Thompson, "Diary," 7 April, 5 May 1933, Thompson Papers.

The House committee adopted the new draft that afternoon, and Chairman Rayburn asked Landis and Cohen to remain as special consultants for the final revisions. The two men devoted long hours to adjusting the finer points of the complex legislation, and fought between themselves over many of its specifics. Cohen proposed to add a detailed list of stock registration requirements to the text of the bill, but Landis argued that such a move would open the door to congressional tinkering, and recommended that they leave those matters to the discretion of the regulatory commissioners. Middleton Beaman, the House legislative draftsman, eventually settled their disagreement by suggesting they put Cohen's list in a separate schedule attached to the bill. He predicted that Congress would exhaust itself over the body of the bill and gloss over the schedule. Beaman reasoned correctly. Neither the committee nor the full House paid much attention to the schedule, which had "the guts of the bill in it." With Ben Cohen sitting by his side to advise on technical matters, a stern Sam Rayburn shepherded the bill through six hours of debate, prevented any amendments, and won unanimous approval. "Everything went on schedule," Cohen reported to Landis. "When it was over, Rayburn remarked that he did not know whether the bill passed so readily because it was so damned good or so damned incomprehensible."[18]

When the Senate-House conference committee met in May, its members carried with them two vastly different securities bills. Sam Rayburn, however, outmaneuvered Duncan Fletcher by calling for a vote to make the Senate bill the basic working draft of the conference. As he expected, the vote was tied. Rayburn thereupon declared the motion defeated and, by default, accepted the House bill as the basic draft. With the advice of Majority Leader Robinson, who spoke for the administration, that "in many respects the House bill is preferable to the Senate bill," the Senate conferees conceded the battle to their House counterparts. By the end of May, Congress passed the House sponsored bill and sent it to the White House. Pecora and his staff were not unhappy over the demise of the Thompson version they had supported. Writing in *The New Republic*, John T. Flynn of Pecora's staff declared that the provisions of the House bill were "so far superior to the Senate bill that it may be said that this bill is good and the Senate bill is worthless."[19]

When Congress adjourned that summer, Pecora laid plans for continued investigation into investment banking. He also informed the Banking Committee that he intended to expand his probe into the workings of the New York Stock Exchange, to see "the way the wheels turn around." Shortly thereafter, those wheels ground to a halt and the market went into its sharpest decline

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[18] Landis, "Legislative History of the Securities Act," 38; Landis Oral History, 161-67; interview with Benjamin Cohen, 9 January 1974; Cohen to Landis, 5 May 1933, Library of Congress, James M. Landis Papers.

[19] Landis, "Legislative History of the Securities Act," 44-49; Joseph T. Robinson to Felix Frankfurter, 9 May 1933, Library of Congress, Felix Frankfurter Papers; John T. Flynn, "Other People's Money," *The New Republic*, LXXVI (31 May 1933), 69-70.

since the crash of October 1929. A cause of the decline was the pending repeal of prohibition, which greatly boosted the price of liquor industry stocks. Then the "bear raiders" moved in to sell short on the popular "wet" stocks, which they unloaded in record numbers. The frenzied selling that followed dragged down the whole "New Deal Market," which had been on the upswing since Roosevelt's inauguration. To Pecora, the spectacle was clearly the work of manipulative pools. On Monday, July 24, he met with New York Stock Exchange President Richard Whitney to discuss his suspicions. "We notice all these things," Whitney assured him. "It's part of our job." The exchange president promised a complete investigation of all pool activities, but Pecora was certain he would never see the results of any such survey. With committee members pressing him to look into the causes of the market collapse, Pecora instructed his staff that he wanted "a deeper incision into the subject so that the public may have a rounded view of the relations of the Stock Exchange to the entire system now under inquiry."[20]

The Stock Exchange presented a different challenge to the investigators. In the case of the investment banks, Pecora could marshal the necessary subpoenas, march his staff into the banks, examine their records, and produce comprehensive pictures of each institution's business. The giant New York Stock Exchange, which handled the majority of the nation's stock transactions, was not a single institution but a trading ground for buying and selling by thousands of brokers. Faced with such an amorphous mass of activity, it was unclear what records the committee should subpoena. Pecora devised a questionnaire concerning pools and other market practices for the exchange to circulate among its members. When Pecora's emissaries presented the questionnaires to Richard Whitney, the exchange president refused to distribute them, protesting: "You gentlemen are making a great mistake. The Exchange is a perfect institution." On the advice of Edward A. Pierce and other brokers opposed to Whitney's dominance of the exchange, Pecora modified his questionnaire and sent it directly to the exchange's 1,375 members. While Pecora continued his dramatic public hearings into the Chase National Bank, Dillon, Read & Company, and other prominent investment banks, his staff compiled, collated, and tried to make sense out of the vast amount of data derived from the returned questionnaire. Their work, as one staff member commented, "went on behind the scenes and got little public notice."[21]

Meanwhile, competition for exchange regulation developed within the administration. In September 1933, President Roosevelt quietly appointed a committee, under the direction of his assistant secretary of commerce, John

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[20] Pecora Oral History, 778-80; "The 'New Deal Market' Feels Its First Shake-Up," *The Literary Digest*, CXVI (5 August 1933), 37; *The New York Times*, 23, 25 July 1933; Memorandum, Max Lowenthal to Frankfurter, 26 July 1933, Frankfurter Papers.

[21] Joseph Alsop and Robert Kintner, "The Battle of the Market Place," *Saturday Evening Post*, CCX (11 June 1938), 9, 74-75; John T. Flynn, "The Marines Land on Wall Street," *Harper's Monthly*, CLXIX (July 1934), 149.

The CHAIRMAN. Our next witness is Edward J. Kelly III, testifying on behalf of Morgan Guaranty Trust. Mr. Kelly, we are delighted to have you here. Go right ahead, sir.

STATEMENT OF EDWARD J. KELLY III, ON BEHALF OF J.P. MORGAN & CO., INC.

Mr. KELLY. Mr. Chairman, I'm pleased to appear before the committee to testify on the legislative history of the Glass-Steagall Act. I've devoted considerable time to this subject over the past several years in connection with my law firm's work for J.P. Morgan & Co., Inc.

During the more than 50 years that have passed since the adoption of the act, a number of misconceptions have developed about its origins, the reasons for its adoption, and its importance. It is these misconceptions that I would like to address today.

MISCONCEPTIONS ABOUT ORIGINS OF GLASS-STEAGALL

Contrary to what the term the "Glass-Steagall Act" may imply, Congress never considered separate legislation that included only the Glass-Steagall provisions. Those provisions were always a small part of much more extensive proposals. When they were finally adopted they represented only 4 of the 34 sections of the Banking Act of 1933 and were a small part of Congress' response to the banking crisis.

In some quarters today, Glass-Steagall is regarded with a reverence generally reserved for matters less mundane than banking regulation. The impression seems widespread that Glass-Steagall embodies a command that came to Congress in a revelation in May 1933. In fact, the roots of Glass-Steagall can be traced to a time well in advance of 1933 or the coming of the New Deal and to sources somewhat less persuasive than is generally assumed.

Work on implementing its concept began in earnest in 1930. Moreover, section 20 was reluctantly proposed in 1932 by Eugene Meyer, a member of the Federal Reserve Board, who repeatedly stressed the absence of full information regarding this proposal, while section 21 was proposed in March 1933 by Winthrop Aldrich, the chairman of the Chase National Bank, which was a competitor of the private banks at which the provision was aimed. At the end of the day, the course of events and Senator Glass' persistence resulted in adoption of what might be more aptly termed the Glass-Meyer-Aldrich provisions of the Banking Act of 1933.

It is commonly asserted today that commercial banks' securities activities caused the banking crisis. This myth appears to be based on two misconceptions.

The first misconception, which is the most prevalent today, is that banks' securities affiliates contributed to the banking crisis by causing the failure of the banks with which they were affiliated. In particular, it is asserted that these failures and Congress' concern over the "risks" associated with underwriting corporate securities led to the adoption of the prohibition in section 20 against affiliations between member banks and firms engaged principally in underwriting corporate securities. The fact is that there is relatively little evidence in the legislative history that Congress was particularly concerned about the "risks" of underwriting, let alone any evidence that the securities affiliates' underwriting activities contributed to the banking crisis by causing the failures of the banks with which they were affiliated.

There is no evidence in the legislative history that the failure of any large bank was attributable to the underwriting or dealing activities of its securities affiliates. As one commentator has observed:

> In reality most banks that had securities affiliates survived the holocaust of bank failures from 1930 through 1933, although the affiliates sustained substantial losses in a number of cases. After an extensive investigation by the Senate subcommittee, only the Bank of United States was singled out as an example of failure caused by the relationship of the bank and its securities affiliate.

The notion that the Bank of United States failed because of its affiliates' underwriting and dealing activities is yet another myth.

The failure of the Bank of United States was due to fraud. The bank's securities affiliates were used principally to conduct the personal and highly speculative business ventures of the bank's officers, particularly in real estate. The affiliates were involved in the securities business only to the extent that they were used to trade in the bank's stock and to engage in other manipulative activities.

The second misconception underlying the myth that commercial banks' securities activities caused the banking crisis is the notion that banks overinvested in unsound securities foisted on them by other banks' securities affiliates. This misconception seems to be based on repeated statements to this effect by Senator Glass and others. During the debate in May 1932, for example, Senator Glass suggested that the banks' securities affiliates had "sent out their high-pressure salesmen and literally filled the bank portfolios of this country with these investment securities."

It is true that the impaired value of banks' assets, including their bond portfolios, was the most important factor leading to bank failures and to the development of the banking crisis. But this impairment in value was not attributable to banks' overinvestment in unsound securities. Instead, it was attributable to the effects of the depression, structural defects in the American banking system, and the failure of the Federal Reserve to use the weapons at its disposal to combat the crisis as it developed. Moreover, Senator Glass' view that the securities affiliates were able to sell securities to smaller banks that the smaller banks would not otherwise have bought is simply implausible.

Of course, it's an irony of Glass-Steagall that it had little if any impact on the perceived problem of bank "over-investment." Section 16 permits national and member banks to invest without limit in a range of government securities and permits them to invest in corporate debt securities subject only to regulations promulgated by the Comptroller. This creates a paradoxical situation in which banks can hold as an investment a 30-year corporate bond that they cannot hold for 30 minutes while underwriting it.

Along with the Securities Act of 1933 and the Securities Exchange Act of 1934, Glass-Steagall is frequently cited as a crucial part of Congress' efforts to prevent a recurrence of the stock market crash and the banking crisis. The fact is that Glass-Steagall was no more indispensable in 1933 than it is today.

Provisions of the Banking Act of 1933 other than the Glass-Steagall provisions addressed more directly and far more effectively the problems that had led to the banking crisis. The strengthening of the Federal Reserve Board, and most importantly the introduction of Federal deposit insurance, were far more important than Glass-Steagall in insuring the stability of banks and restoring public confidence in the system as a whole.

With respect to the problems and abuses Congress perceived to be associated with commercial banks' securities activities, it is important to distinguish between those that were common to the securities industry as a whole during the 1920's and those that were peculiar to commercial banks' involvement in the securities markets. The abuses that were generally a problem in the securities industry, such as failures to disclose material facts, high-pressure sales tactics, and market manipulation, were addressed by the Securities Act of 1933 and the Securities Exchange Act of 1934. Banks or their affiliates would be no more likely to engage in those abuses today than securities firms.

Of the problems and abuses perceived by Congress that were peculiar to commercial banks' securities activities, the use of an affiliate to manipulate the price of a bank's own stock was addressed by the Securities Exchange Act of 1934. Moreover, the Banking Act of 1933 added a new section 23A to the Federal Reserve Act which restricted extensions of credit by member banks to their affiliates. This new section addressed concerns over the possibility that banks would lend too freely to their securities affiliates. By strictly limiting the loans a bank could make to its affiliates, the section also reduced substantially the possibility that depositor confidence in a bank might be shaken by the existence of an unprofitable affiliate. The Banking Act of 1933 also introduced affiliate reporting and examination requirements.

Once the myths about Glass-Steagall have been dispelled, it should be possible to assess objectively and accurately the costs and benefits associated with its provisions. By 1935, Senator Glass himself had made such an assessment and had changed his views. In connection with Congress' consideration of the Banking Act of 1935, Glass supported a proposal, which was radical by today's standards, that would have permitted national and member banks, as opposed to their affiliates, to underwrite "investment securities." Glass was concerned about the absence of "underwriting houses" to assist in the recovery of the "heavy-goods industries."

It is encouraging that this committee is now undertaking a reexamination of Glass-Steagall and the regulation of the financial services industry. It is no less important today than it was in 1935 to insure that American businesses can raise capital quickly and efficiently. Providing for increased competition in the securities markets would be a significant step toward achieving that goal.

Thank you, Mr. Chairman.

[The complete prepare statement of Edward J. Kelly III follows:]

Dickinson, to prepare exchange regulation proposals. Pecora and his staff were distrustful of the committee, which included Arthur Dean of Sullivan & Cromwell, the leading Wall Street critic of the Securities Act, Henry Richardson, a conservative Washington lawyer, Adolph A. Berle, Jr., and Dickinson, himself a former Sullivan & Cromwell attorney who had specialized in defending corporations against anti-trust suits. "The right hand knoweth not what the left hand doeth," moaned Ben Cohen when he learned about the Dickinson committee. Cohen feared that the committee would try to water-down the Securities Act with amendments and delay effective exchange regulation.[22]

Chairman Fletcher also was concerned about the affect the Dickinson committee might have, and requested that Pecora prepare exchange legislation for the Banking Committee by January 1, 1934. Pecora was still immersed in the Chase National Bank hearings, and making new headlines with his incriminating evidence against Chase's retired president, Albert Wiggins. Pecora had an able staff, but felt it could not do justice to two projects at once. He sent one of his assistants, Max Lowenthal, also a former Frankfurter law student, to ask Cohen, Corcoran, and Landis to draft the legislation. All were busy with other New Deal assignments, but Landis, than a Federal Trade Commissioner, assigned two of his assistants, Isaac Newton Phelps Stokes III and Telford Taylor, to prepare the initial drafts. Cohen and Corcoran devoted their evenings, weekends, and Christmas vacation to revising the numerous drafts. Landis arranged to have himself appointed to the Dickinson committee, where he spent his days working with the business accomodationists of the committee, and his nights with the determined reformers of Pecora's staff, trying to convince each side "to think it was their bill" being created. The Frankfurter group had its own opinion as to what the legislation should entail. They considered Pecora a "great investigator," but not a "creative artist" when it came to legislation. "We built completely on his work," Landis explained, "but he just doesn't have that quality of putting together the work in the form of draft legislation."[23]

In January, the Dickinson committee submitted its predictably moderate report. Instead of drafting a bill, the committee made suggestions for federal licensing of exchanges under the supervision of a "Federal Stock Exchange Authority," one of whose members would represent the stock markets. The report further advised against specific prohibitions against pools, short selling, wash sales, and other controversial market practices. "The thing to be avoided," it emphasized, "is the placing of this complex machinery in a strait

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[22] Lowenthal to Frankfurter, 3, 26 October 1933, Cohen to Frankfurter, 9 October 1933, Frankfurter Papers.

[23] Alsop and Kintner, "Battle of the Market Place," 75, interview with Benjamin Cohen, 9 January 1974, interview with Telford Taylor, 6 March 1974, Calvert Magruder to Frankfurter, 17 February 1934, Frankfurter Papers, Landis Oral History, 199.

jacket." Dickinson's report dismayed the Banking Committee investigators as much as it gratified Wall Street. When Pecora termed it "inadequate," Chairman Fletcher and Michigan Republican James Couzens asked him to produce his counter-proposals. Temporarily relieved from examining witnesses, Pecora and his staff hastily met with Cohen and Corcoran to review the bill, which they found far too lenient. The acerbic financial critic, John T. Flynn, in particular, demanded a far stronger measure and warned that shrewd corporate lawyers would seize upon any ambiguities to subvert the bill's intent. With the prodding of Pecora's men, Cohen and Corcoran revised the draft to set a 60 percent margin requirement for stock purchases, separate broker and trader functions, outlaw all pools, wash sales, short selling, and matched orders, and require all stock-issuing corporations to file annual, quarterly, and monthly financial reports with the Federal Trade Commission. While Landis again argued for a more flexible measure, leaving most of the issues to the discretionary power of the regulatory agency, Cohen and Corcoran felt they were working for Pecora and would adhere to his wishes. Working around the clock for forty-eight hours, they produced a draft that Pecora accepted.[24]

Before the bill was introduced in Congress, President Roosevelt summoned Landis and Pecora to the White House. Meeting in the president's bedroom, where he sat in bed surrounded by reports and papers, they explained the various provisions of the bill until he finally responded: "All right, go ahead." Later, Roosevelt met with Chairman Fletcher and Rayburn and encouraged them to introduce the bill "as the basis for consideration." Publicly, however, the president chose to remain neutral, for he knew that considerable opposition to such a strong bill existed within the Treasury and Commerce Departments and the Federal Reserve Board. Roosevelt's hesitancy made the congressional leaders' job more difficult. "One word from Franklin D. Roosevelt and the dramatic first bill would have been passed with a whoop," John Flynn complained. "Mr. Roosevelt made a speech about a bill 'with teeth in it' while his department subordinates performed their dental depredation behind the scenes."[25]

On February 9, 1934, Roosevelt sent his special message to Congress requesting stock exchange regulation, but without committing himself to the specific legislation which Fletcher and Rayburn introduced. On Wall Street, where the temperate nature of the Dickinson report had lulled investment bankers and brokers, the stringency of the Fletcher-Rayburn bill came as a bombshell. The financial press exuded hostility. ***Business Week***, for one, charged that the bill "lays hands on delicate machinery with all the finesse of a Russian peasant."[26]

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[24] U.S. Congress, Senate, Committee on Banking and Currency, *Stock Exchange Regulation, Letter from the President of the United States to the Chairman of the Committee on Banking and Currency, With and Accompanying Report Relative to Stock Exchange Regulation*, 73, Cong., 2 sess., 23 January 1934, *The New York Times*, 31 January 1934, Parrish, *Securities Regulation*, 115-20; interview with Thomas Corcoran, 21 March 1974.

[25] Landis Oral History, 199, Flynn, "Marines Land on Wall Street," 148.

Richard Whitney arrived in Washington to lead the lobbying against the bill personally. In his quest, Whitney left no tactic untried. He announced new exchange rules for self-regulation which would prohibit pools and limit the power of floor traders. He stimulated a letter writing campaign against the bill by notifying all 800 presidents of corporations whose stocks were listed on the New York Stock Exchange that the Fletcher-Rayburn bill would enable the FTC to "dominate and actually control" their businesses. Finally, he testified before both House and Senate committees, where he proposed a "Federal Stock Exchange Coordinating Authority," similar to that recommended by Dickinson, to include representatives of the president, Congress, and the Exchange. Whitney's efforts soon had their affect. "The Stock Exchange bill is receiving a terrific beating," James Landis reported. "My office for the last three weeks has been a general reception room for brokers, bankers, and the like who come in and tell me their troubles." Adding to Whitney's barrage, John Dickinson testified that the bill's high margin requirements would cause widespread selling of stock and have a deflationary affect. Shortly after Dickinson's damaging testimony, word leaked out that the president favored modifying the bill. Fletcher, Rayburn, and Pecora all confirmed that some revisions were imminent.[27]

Concerned with the bill's influence on the national credit system, Treasury Department and Federal Reserve officials intervened in the redrafting. Tom K. Smith, an investment banker serving as assistant secretary of the treasury, led the movement to reduce margin requirements. In a series of meetings, Smith and other business friends in the administration proposed numerous amendments and revisions, which they hoped would delay completion of the bill until after Congress had recessed for the summer. But Cohen and Corcoran worked feverishly each night to meet their objections by the next morning. After eight days of repeating that pattern, they forced Smith to accept a compromise. During the final weekend meeting, while Pecora was absent in New York, Landis, Cohen, Corcoran, and Treasury and Federal Reserve representatives agreed on a plan for an elastic margin system. When Pecora returned and learned of the meeting he indignantly objected to the changes, but by then they already had received the administration's stamp of approval. John T. Flynn spoke for Pecora when he charged that the revisions had extracted from the bill "almost all of it teeth."[28]

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[26] *Business Week* (3 March 1934), 36.

[27] Richard Whitney to Presidents of all Listed Corporations, 14 February 1934, "Petition on Behalf of the Floor Traders of the New York Stock Exchange, 24 March 1934," Landis Papers; Landis to Frankfurter, 6 March 1934, Frankfurter Papers; *The New York Times*, 15, 23 February, 9-14 March 1934; *Time*, XXIII (26 February 1934), 54-56.

[28] Interview with Benjamin Cohen, 9 January 1974; interview with Thomas Corcoran, 21 March 1974; *The Wall Street Journal*, 24 March 1934; Flynn, "Marines Land on Wall Street," 151.

The revised stock exchange bill, which Fletcher and Rayburn introduced in mid-March, revealed pragmatic changes. To settle the uncertainties over the national credit system, it granted the Federal Reserve Board power to raise and lower margin rates, while designating the FTC to administer the rest of the act. To ease the fears of the smaller exchanges, which believed that any separation of broker and dealer functions would destroy their business, it prohibited dealers only from acting as brokers for their own accounts. To quiet Wall Street's uproar over the Securities Act, which had stopped almost totally, the issuance of new stocks, it reduced the criminal liability provisions. As usual, Richard Whitney was among the first to criticize the bill as "destructive." But, as Pecora pointed out, "If all of Mr. Whitney's objections were met, there would be no bill at all."[29]

The fight had not yet ended. Bankers and brokers opposed to the bill continued to deluge Congress with mail, filling several baskets in the Senate Banking Committee room alone. Despite President Roosevelt's assurances that the mail bore "all the earmarks of origin at some common source," members of Congress could not ignore the volume of protest. In the Senate Banking Committee, Carter Glass took full advantage of other members' doubts. Primarily, Glass wanted to protect his own legislative creation, the Federal Reserve Board, from becoming "mixed up with stock market gambling" by setting margin requirements. In two close committee votes, he received approval of amendments to eliminate fixed margin provisions and to establish a separate Securities and Exchange Commission to administer the act. While at first glance Glass's new commission resembled Whitney's proposal, Glass dismissed this view as "gross error." Stressing that his only concern was for the Federal Reserve Board, he insisted that "Mr. Whitney's ideas and mine are as different as night and day." Glass had not provided for any exchange representation on the new commission, and promised that "not a single tooth has been drawn" from the bill. In that roundabout fashion, Carter Glass became the "father" of the Securities and Exchange Commission.[30]

By the end of April, the two committees reported out their own versions of the stock exchange bill. Sam Rayburn led the administration forces in the House with an impassioned attack on the New York Stock Exchange for its massive propaganda campaign. Republicans countered with an attack on the bill's authors, Cohen and Corcoran, whom they dubbed "the scarlet fever boys from the little red house in Georgetown." Representative Fred Britten of Illinois accused Cohen and Corcoran of kidnapping the exchange bill and trying to "Russianize everything worthwhile under the unqualified and unprepared Federal Trade Commission." After a fierce fight, Rayburn won approval of the bill 280 to 84. The Senate adopted its own measure 62 to 13, with the choice of administering agencies the chief difference between the two bills.[31]

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[29] *The Wall Street Journal*, 20 March 1934; *The New York Times*, 20 March 1934.

[30] Franklin D. Roosevelt, *The Public Papers and Addresses of Franklin D. Roosevelt*, ed. by Samuel I. Rosenman (13 vols., New York, 1938-50), III, 169-70; *The New York Times*, 4, 10, 12 April 1934; *Business Week* (14 April 1934), 39; Parrish, *Securities Regulation*, 131-36.

Roosevelt leaned toward the House bill. He opposed any new independent commission outside of his control, and was satisfied with the job the FTC had done in handling the Securities Act. Senator Fletcher supported the president and sought to assure a pliable Senate delegation to the conference committee. He passed over the two senior members of the Banking Committee, Carter Glass and New York's Robert Wagner, who favored a Securities and Exchange Commission, and chose Alben Barkley (Ky.) and James Byrnes (S.C.), who supported the administration-backed FTC plan. In a furor, Glass loudly resigned from the Banking and Currency Committee. It was only a symbolic gesture, for Majority Leader Robinson refused to accept his resignation, but the move sufficiently embarrassed Barkley and Byrnes to make them feel honor-bound to support the Senate version of the bill.[32]

Members of the conference finally reached an agreement that, in some respects, disappointed all sides. To the president's regret, they supported Glass's plan for a new five member SEC. But to Glass's dismay, they denied his fundamental objective by placing margin requirements under the control of the Federal Reserve Board. To Pecora and his staff, the original teeth of the bill, high margins, outlawing of short selling, pools, and other dubious practices, were extracted and left to future study by a new commission of unpredictable membership and direction. Still, Senator Glass reluctantly agreed to support the bill, President Roosevelt indicated his approval, and Pecora termed it a "happy compromise." Cohen and Corcoran were most pleased with the outcome. They had written the original bill tougher than they planned, to meet Pecora's specifications, and after all the challenges, modifications, and amendments, they believed they never could have gained as much power for the new commission if the first draft had not been so strong. On June 1, 1934, the House and Senate passed the Securities and Exchange Act without roll call votes. Five days later the president signed it into law.[33]

Enactment of the Securities and Exchange Act completed the work of the Pecora investigation. As Pecora prepared his final report and began to disband his staff, many of those around him urged him to continue the probe. Max Lowenthal insisted that the recent legislation left wide areas of financial abuse untouched, and suggested that Pecora look into the role of insurance companies on Wall Street, the financial manipulation of railroads, the problems with corporate bankruptcy proceedings, and the overall concentration of wealth. "To a great host of people, this investigation is a cherished cause," Lowenthal exhorted, "and promises much more even than that quickening of conscience in high places that you have brought forth wherever you have ploughed." Further investigation could provide the information and publicity to stimulate new legislation with which "the country may achieve a fairer life." But the decision to extend or discontinue the investigation rested solely with the senators of the Banking and Currency Committee, and they, after more than two years of hearings, were more than willing to see future investigations conducted under the auspices of the Securities and Exchange Commission.[34]

Pecora finished his work with a sense of pride and accomplishment. The charges of political motivation and lack of legislative recommendations leveled against so many other congressional investigations were inapplicable to his hearings. "Why unearth the carcass," Woodrow Wilson had asked, "if you cannot remove it?" That theme characterized the Wall Street investigation. Pecora was unwilling to stop at gathering information and generating publicity; he intended to rid society of the financial ills he uncovered. Through the revelations of the Banking Committee investigation, he kept alive the Glass-Steagall bill and spurred federal regulation of securities and the stock exchanges despite heavy Wall Street opposition. But the chores of conducting the hearings and drafting the legislation were monumental, and handling both proved beyond his capabilities. Pecora's contribution was essential, but limited. He had all he could do to unearth the carcass; others had to remove it.[35]

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[31] House, *Congressional Record*, 73 Cong., 2 sess., vol. 78, pt. 7, 7693-98; *ibid.*, Senate, 7943-44.

[32] *Time*, XXIII (28 May 1934), 11; Landis Oral History, 188-89.

[33] *The New York Times*, 27 May 1934; John T. Flynn, "Other People's Money," *The New Republic*, LXXIX (13 June 1934), 127-28; interview with Benjamin Cohen, 9 January 1974.

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[34] Lowenthal to Pecora, 12 May 1934, Frankfurter Papers.

[35] Woodrow Wilson, *Congressional Government, A Study in American Politics* (New York, 1956), 184.

STATEMENT OF EDWARD J. KELLY, III
BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Mr. Chairman, I am pleased to appear before the Committee to testify on the legislative history of the Glass-Steagall Act.* I have devoted considerable time to this subject over the past several years in connection with my law firm's work for J. P. Morgan & Co. Incorporated.

As you know, the Glass-Steagall Act is commonly understood to consist of four provisions of the Banking Act of 1933 that to some degree separate "commercial" from "investment" banking. Sections 16 and 21 of the Act restrict the securities activities in which deposit-taking institutions may engage. Section 20 prohibits affiliations between member banks and firms "engaged principally" in underwriting corporate securities. Finally, Section 32 prohibits personnel interlocks between member banks and firms "primarily engaged" in underwriting corporate securities.

During the more than 50 years that have passed since the adoption of the Act, a number of misconceptions have developed about the origins of the Act, the reasons for its adoption, and its importance. It is these misconceptions, or the "mythology" of Glass-Steagall, that I would like to address today.

The "Glass-Steagall Act" Was A Small Part of Comprehensive Banking Legislation

Contrary to what the term the "Glass-Steagall Act" may imply, Congress never considered separate legislation that included only the Glass-Steagall provisions. Those provisions were always a small part of much more extensive proposals. When they were finally adopted they represented only four of the thirty-four sections of the Banking Act of 1933. That comprehensive legislation, which was enacted in response to the collapse of the nation's banking system, was designed to insure the stability of commercial banks and to restore public confidence in the system as a whole. It included provisions that created the Federal Deposit Insurance Corporation; prohibited member banks from paying interest on demand deposits; strengthened the minimum capital requirements for the organization of national banks and for admission to the Federal Reserve System; provided expanded branching authority for national banks; strengthened the Federal Reserve Board; created a statutory Federal Open Market Committee; authorized the Federal Reserve Board to monitor and control the use of the Federal Reserve System's credit facilities, with a view to preventing the use of such facilities to support speculation in securities and real estate; restricted loans from member banks to their affiliates; and subjected affiliates of member banks to reporting requirements and examination by federal banking regulators.

In short, the Glass-Steagall provisions never formed part of a separate "Act," and they were only a small part of Congress' response to the banking crisis.

The "Glass-Meyer-Aldrich" Act

In some quarters today, Glass-Steagall is regarded with a reverence generally reserved for matters less mundane than banking regulation. The impression seems widespread that Glass-Steagall embodies a command that came to Congress in a revelation in May 1933. In fact, the roots of Glass-Steagall can be traced to a time well in advance of 1933 or the coming of the New Deal and to sources somewhat less persuasive than is generally assumed.

In May 1930 the Senate passed a modified version of a resolution originally introduced a year earlier that authorized the Committee on Banking and Currency "to make a complete survey" of the national and Federal Reserve banking systems, with particular attention to the uses of credit to support speculative securities activities and to the effect on such systems of the formation of "investment and security trusts." From there, Senator Carter Glass of Virginia took command.

It is impossible to understand Glass-Steagall without understanding the views of Senator Glass. Glass believed that commercial and investment banking were inherently incompatible and that commercial banks should confine themselves to making short-term, self-liquidating loans to finance commercial transactions. At the Senate Brokers' Loans hearings in 1928 he expressed grave concern about the volume of commercial banks' loans to brokers and the apparent use of the Federal Reserve System's credit facilities to fund these loans. He stated that the framers of the Federal Reserve Act, of whom he had been one, thought "we should have a system that would meet the requirements of legitimate industry and commerce, and not a system that would lend itself to what many of us regard as an unproductive operation of stock and commodity gambling."* Glass believed that banks should be "strictly commercial institutions"** and viewed banks' participation in the securities markets as inconsistent with sound banking practice.***

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* In an effort to be fully responsive to the Committee's request, I have attached as Exhibit A an article I wrote which discusses in detail the legislative history of the Act. Most of the material in this statement is drawn from that article. The sources for the material not drawn from the article are noted at the appropriate points in this statement.

The passage of the Senate resolution in May 1930 provided Senator Glass with an opportunity to press his views. In June 1930 Glass introduced the first of a series of bills that included various formulations of one or more of the provisions that are referred today as the Glass-Steagall Act. He described it as "merely a tentative measure to which I hope to direct the Senate inquiry into the banking

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* Brokers' Loans: Hearings Before the Senate Comm. on Banking and Currency on S. Res. 113, 70th Cong., 1st Sess. 53 (1928). Senator Glass apparently never recognized the important role that strong secondary markets in securities play in businesses' ability to raise capital.

** Operation of the National and Federal Reserve Banking Systems: Hearings Pursuant to S. Res. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency, 71st Cong., 3d Sess. 19 (1931) (statement of Sen. Glass) [S. Res. 71 Hearings].

*** The theoretical basis of Glass' views was the "real bills" doctrine, which was basically a theory of monetary policy that has been "long-discredited." Humphrey, The Real Bills Doctrine in Federal Reserve Bank of Richmond, Economic Review, 3 (Sept./Oct. 1982). See also L. Mints, A History of Banking Theory, 5 (1945).

system."* In early 1931, although he was a member of the minority party at the time, he chaired the subcommittee that conducted the hearings authorized by the resolution and he participated actively, to say the least, in the Senate Committee on Banking and Currency's hearings on one of his bills in March 1932.

The 1932 hearings are particularly noteworthy because they marked the first appearance of a provision basically identical to Section 20 of Glass-Steagall. This provision was proposed not by Senator Glass, but by Eugene Meyer, who testified on behalf of the Federal Reserve Board. During his testimony, Governor Meyer criticized one part of a predecessor of Section 32 as "capable of easy evasion" and the other part as overly broad. He then offered a substitute that was basically identical to Section 20. Meyer's endorsement of the substitute was less than ringing. He described the proposal as "the best [the Board] could think of at the present time in the light of existing information, or I might say in the absence of full information on the subject." He went on to state: "We do not feel, in the absence of more definite information, any too great confidence in any recommendation that we or anyone else could make. But this is a suggestion for your consideration, which was the best we could evolve in the board with the assistance of our experts." Later, in what appears to have been a fairly animated colloquy with Senator Glass, Meyer declined "to classify all affiliates that deal in securities as wicked and vicious." He later expressed sympathy with Glass' stated desire to "eliminate . . . . those affiliates that are doing that wretchedly bad business," but he again stressed the inadequacy of the information available.*

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* 72 Cong. Rec. 10,973 (daily ed. June 17, 1930). The bill included a provision similar to Section 16 of Glass-Steagall, along with several other provisions relating, among other things, to national bank branching, reporting requirements for member bank affiliates, the membership of the Federal Reserve Board, member banks' uses of advances made to them by the Federal Reserve banks, national banks' real estate lending, and the interest rates charged by national banks on loans.

Following the hearings, Glass incorporated Meyer's proposal into a new bill. The Senate debated Glass' new bill in May 1932, but failed to act on it. In January 1933, during the lame-duck session of the 72nd Congress, Glass persuaded the Senate to pass his bill, but was thwarted again when the House failed to act before the end of the Congress. Senator Glass needed help and in early 1933 he got it.

First, in late January 1933 Ferdinand Pecora was retained as counsel to the subcommittee of the Senate Committee on Banking and Currency investigating stock exchange practices. Although the bulk of the "Pecora hearings," as they have come to be known, occurred subsequent to the adoption of Glass-Steagall, in February and March 1933 the hearings focused attention on the activities of a commercial bank and its affiliate. The hearings suggested, among other things, that the bank and its affiliate had failed to disclose material facts to investors; the affiliate had traded in the stock of the bank and engaged in manipulative activities; and the affiliate had engaged in high-pressure sales tactics.

Second, and most importantly, the failures of small banks that had plagued the nation since the early 1920s finally triggered a full-fledged crisis that culminated in President Roosevelt's declaration of a national bank holiday in March 1933. Although this action, combined with Congress' enactment of emergency banking legislation in early March,**

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* Operation of the National and Federal Reserve Banking Systems: Hearings On S. 4115 Before the Senate Comm. on Banking and Currency, 72d Cong., 1st Sess. 387, 388, 389, 392 (statement of Sen. Glass), 393 (statement of Gov. Meyer) (1932).

** This legislation, among other things, granted the President certain emergency banking and currency powers; provided for the appointment of conservators for certain national banks with impaired assets; permitted the Reconstruction Finance Corporation to buy preferred stock, capital notes and debentures of banks; and provided for emergency issues of Federal Reserve Bank notes. See M. Friedman & A. Schwartz, A Monetary History of the United States 1867-1960, 421-22, 427 n.4 (1963).

stabilized the situation and permitted the reopening of most of the surviving banks, a consensus was beginning to develop on the need to reform the banking structure and, in particular, on the need for federal deposit insurance. Although Senator Glass had opposed deposit insurance and had favored the creation of a corporation to assist in the liquidation of the assets of closed member banks, the stage was now set for a compromise between Glass and Representative Henry Steagall of Alabama. Steagall was the chairman of the House Banking Committee and a proponent of deposit insurance.* Ironically, Representative Steagall deserves little of the credit, or blame, for the provisions that now bear his name.

Finally, Winthrop Aldrich, the new chairman of the Chase National Bank, announced in March that he supported a separation of commercial and investment banking and that the Chase would sever its ties to its securities affiliate. This represented a crucial break in the banking community's opposition to Glass' bill. As part of his announcement, Aldrich made several proposals that were purportedly designed to strengthen the separation of commercial and investment banking contemplated by Glass' bill.

A close examination of Aldrich's announcement, and of his proposals, suggests that his motives were open to question. At the time of his announcement, "many . . . affiliates were already in the process of liquidation, or had been previously dissolved, either because final passage of the Glass bill was anticipated or because banks welcomed the opportunity to rid themselves of affiliates which they had thought necessary or highly desirable during the twenties."** As Professor Perkins has pointed out, the securities business had dropped off substantially, and "no one was prepared to predict how soon, if ever again, this commercial banking sideline might be able to pay its own way."* In fact, new corporate securities offerings had declined from $9.4 billion in 1929 to less than $400 million in 1933 -- a 95 percent drop.** A cynic might suggest that Aldrich had exchanged an affiliate he no longer needed for recognition as a "reformer."

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* Provisions creating a "Federal Bank Deposit Insurance Corporation" appeared for the first time in one of Glass' bills in May 1933. S. 1631, 73d Cong., 1st Sess., 77 Cong. Rec. 3109 (daily ed. May 10, 1933).

** Peach, The Security Affiliates of National Banks, in Wall Street and the Security Markets, 158 (V. Carosso ed. 1975).

Moreover, Aldrich's proposals, while cast as "reforms," were clearly aimed at the Chase's private bank competitors and, in particular, at J. P. Morgan & Co. The private banks, which were organized in partnership form, took deposits and engaged in securities underwriting. Aldrich suggested that partnerships dealing in securities should be prohibited from taking deposits. As Arthur Schlesinger has pointed out, Aldrich's proposal was "interpreted [on Wall Street] as a Rockefeller assault on the House of Morgan." Another commentator has stated that "Aldrich generously suggested a program whereby the rival house of J. P. Morgan and Company could follow his good example."*** In fact, Aldrich later took credit for drafting Section 21 of Glass-Steagall. This provision forced J. P. Morgan & Co., and the other private banks, such as Kuhn, Loeb, to choose between deposit-taking and securities underwriting.

Drawing on the support provided by these events, and thanks to Meyer and Aldrich armed with a complete package of "reforms," Glass finally prevailed when the Senate passed the Banking Act of 1933 in May. Following a House-Senate conference, the bill was signed into law in June.

It is apparent that Glass-Steagall was not the product of a revelation in May 1933. Work on implementing its concept had begun in earnest three years before. Moreover, Section 20 was reluctantly proposed by a member of the Federal Reserve Board who repeatedly stressed the absence of full information regarding his proposal, while Section 21 was proposed by a competitor of the private bankers at whom the provision was aimed. At the end of the day, the course of events and Senator Glass' persistence resulted in adoption

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* Perkins, The Divorce of Commercial and Investment Banking: A History, 88 Banking L. J. 483, 486 (1971).

** Board of Governors of the Federal Reserve System, Banking and Monetary Statistics 1914-1941, 489 (1943).

*** A. Schlesinger, The Age of Roosevelt: The Coming of The New Deal, 434-35 (1958); S. Kennedy, The Banking Crisis of 1933, 212 (1973).

of what might be more aptly termed the "Glass-Meyer-Aldrich" provisions of the Banking Act of 1933.

Commercial Banks' Securities Activities Did Not Cause The Collapse of the Banking System

It is commonly asserted today that commercial banks' securities activities caused the collapse of the banking system. This myth appears to be based on two misconceptions.

The first misconception, which is the most prevalent today, is that banks' securities affiliates contributed to the collapse of the banking system by causing the failure of the banks with which they were affiliated. In particular, it is asserted that these failures and Congress' consequent concern over the "risks" associated with underwriting corporate securities led to the adoption of the prohibition in Section 20 against affiliations between member banks and firms "engaged principally" in underwriting corporate securities. The fact is that there is relatively little evidence in the legislative history that Congress was particularly concerned about the "risks" of underwriting, let alone any evidence that the securities affiliates' underwriting activities contributed to the collapse of the banking system by causing the failures of the banks with which they were affiliated.

There is no evidence in the legislative history that the failure of any large bank was attributable to the underwriting or dealing activities of its securities affiliates.* As one commentator has observed: "In reality, most banks that had securities affiliates survived the holocaust of bank failures from 1930 through 1933, although the affiliates sustained substantial losses in a number of cases. After an extensive investigation by the Senate Subcommittee, only the Bank of United States was singled out as an example of failure caused by the relationship of the bank and its securities affiliate."* Of course, the notion that the Bank of United States failed because of its affiliates' underwriting and dealing activities is yet another myth.

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* Ironically, the Pecora hearings suggested that the underwriting activities of securities affiliates had generated substantial profits. See Stock Exchange Practices: Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency, 72d Cong., 2d Sess., 1769-79 (1933).

The failure of the Bank of United States was due to fraud. The bank's president and one of its directors were prosecuted and convicted. Moreover, the bank's "securities affiliates" were used principally to conduct the personal, and highly speculative, business ventures of the bank's officers, particularly in real estate. The affiliates were involved in the securities business only to the extent that they were used by the bank's officers to trade in the bank's stock and to engage in other manipulative activities. In the appendix to the Senate hearings in 1931, even the subcommittee attributed the failure of the Bank of United States to its affiliates' activities in supporting the bank's stock, with the proceeds of loans from the bank.** On the Senate floor in 1932, Senator Walcott attributed the bank's failure to its use of affiliates for real estate speculation.***

In short, the failure of the Bank of United States, which was the only bank failure attributed to a bank's relationship with a "securities affiliate," was not caused by its affiliates' securities underwriting or dealing activities. Part of the confusion may stem from Congress' imprecise use of the term "securities affiliate." In the appendix to the 1931 hearings the subcommittee used the term to include: wholesalers of securities; retailers of securities; holding and finance companies; investment trusts; asset realization companies; real estate holding companies; and mediums for supporting the bank's own stock.**** In

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* Upshaw, *Bank Affiliates And Their Regulation*, in Federal Reserve Bank of Richmond, Monthly Review 14, 17 (March 1973).

** S. Res. 71 Hearings, p. 3 *supra*, at 1017, 1058.

*** 75 Cong. Rec. 9905 (daily ed. May 10, 1932).

**** S. Res. 71 Hearings, p. 3 *supra*, at 1057.

keeping with Senator Glass' views, it was a term used to cover what he perceived to be a multitude of sins.*

The second misconception underlying the myth that commercial banks' securities activities caused the collapse of the banking system is the notion that banks "overinvested" in unsound securities foisted on them by other banks' securities affiliates. This misconception seems to be based on repeated statements to this effect by Senator Glass and others. During the Senate debate in May 1932, for example, Senator Glass suggested that the banks' securities affiliates had "sent out their high-pressure salesmen and literally filled the bank portfolios of this country with these investment securities." At one point he asserted that "the great banks in the money centers choked the portfolios of their correspondent banks from Maine to California with utterly worthless investment securities nearly eight billion of them being the investment securities of tottering South American republics and other foreign countries." Senator Walcott stated that "[w]e have banks that have closed their doors because they have overpurchased, as correspondent banks of some of the larger ones, the very securities that the larger banks have forced upon them."**

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* It is interesting to note that the number of national and state member banks operating "securities affiliates" actually engaged in underwriting and dealing in securities reached its peak in 1930 when 105 national banks and 75 state banks operated such affiliates. By 1933, 76 national banks and 32 state banks were operating such affiliates, but this decline "does not appear to have been due to failures of affiliated banks." *See* Peach, p. 6 *supra*, at 83; Upshaw, p. 9 *supra*, at 17. As discussed above, many banks dissolved their affiliates either in response to the sharp decline in the underwriting business or in anticipation of the passage of Glass' bill. *See also* White, *Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks*, Explorations in Economic History, 33, 41 (1986) (Analysis suggests that "any type of securities operation did not increase the probability of bank failure. Furthermore, the presence of a security affiliate and whatever characteristics were associated with it tended to reduce the likelihood of failure").

** 75 Cong. Rec. 9887, 9883 (daily ed. May 10, 1932) (statements of Sen. Glass); *id.* at 9906 (statement of Sen. Walcott).

It is true that the impaired value of banks' assets, including their bond portfolios, was the most important factor leading to bank failures and to the collapse of the banking system. But this impairment in value was not attributable to banks' "overinvestment" in unsound securities. Instead, it was attributable to the effects of the depression, defects in the American banking structure, and the failure of the Federal Reserve to use the weapons at its disposal to combat the crisis as it developed. Moreover, Senator Glass' view that the securities affiliates were able to sell securities to smaller banks that the smaller banks would not otherwise have bought is simply implausible.

Professor Galbraith has made the following observation about the American banking structure in 1929:

> "[A]lthough the bankers were not unusually foolish in 1929, the banking structure was inherently weak. The weakness was implicit in the large numbers of independent units. When one bank failed, the assets of others were frozen while depositors elsewhere had a pregnant warning to go and ask for their money. Thus one failure led to other failures, and these spread with a domino effect . . . . When income, employment and values fell as the result of a depression bank failures could quickly become epidemic. This happened after 1929 . . . . It would be hard to imagine a better arrangement for magnifying the effects of fear. The weak destroyed not only the other weak, but weakened the strong."*

As Professor Galbraith suggests, there were 24,912 separately incorporated banks scattered across the country in June 1929. Of these banks, 72 percent had capital of less than $100,000. Many of them were subject to rigid branching laws, and were poorly managed, inadequately supervised, and

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* J. Galbraith, The Great Crash 1929, 184-85 (3d ed. 1973).

too dependent on one crop or one industry.* The devastating effects of a significant economic downturn on such a weak banking system are not hard to imagine. Between 1929 and 1933 "net national product fell by more than one-half in current prices, more than one-third in constant prices, and more than one-third in monthly wholesale prices."** Ultimately, the failure of the small banks led to an erosion of depositor confidence, to hoarding, and to runs.

In the face of actual or anticipated runs, banks were forced to achieve greater liquidity by dumping their assets on the market. This had the predictable effect of reducing the value of the banks' remaining assets and making them all the more vulnerable to assaults by depositors. Friedman and Schwartz have described this phenomenon as follows:

> "[A]ny runs on banks for whatever reasons became to some extent self-justifying, whatever the quality of assets held by banks. Banks had to dump their assets on the market, which inevitably forced a decline in the market value of those assets and hence of the remaining assets they held. The impairment in the market value of assets held by banks, particularly in their bond portfolios, was the most important source of impairment of capital leading to bank suspensions, rather than the default of specific loans or of specific bond issues."***

Similarly, the President's Council of Economic Advisers has stated:

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* These problems also were reflected in the more than 5000 bank failures that had hit the nation during the 1920s.

** S. Kennedy, p. 7 supra, at 18-19.

*** M. Friedman & A. Schwartz, p. 5 supra, at 355. Friedman and Schwartz suggest that "[i]f there was any deterioration at all in the . . . quality of loans and investments of banks [from the early 1920s to the late 1920s], it must have been minor, to judge from the slowness with which it manifested itself." Id. at 354.

> "It is now widely asserted that the length and severity of the banking collapse of the 1930s *was not the result of overly risky bank portfolios*. Rather, many economists argue that these failures became widespread, initially, because of the reluctance of the Federal Reserve System to engage in aggressive open market operations to counter the conversion of deposits to currency and, later, because of the Federal Reserve's failure to assure adequate liquidity to banks experiencing runs on their deposits. As banks scrambled to liquidate their assets to meet the demands of their depositors for currency, their asset values fell, thus creating insolvencies."*

This analysis suggests that there was no validity to Glass' notion that banks' "overinvestment" in speculative securities sold to them by other banks' securities affiliates had led to the collapse of the banking system.

Finally, it is simply implausible that the securities affiliates were able to create an artificial demand for securities or to sell securities to smaller correspondent banks that the smaller banks would not otherwise have purchased. There was a natural increased demand for investment securities among banks during the 1920s due to factors such as the decline in the banks' commercial lending business. The business boom during the 1920s, combined with the public's interest in securities, made it possible for businesses to pursue "internal and external financing not involving bank loans."** In view of these conditions, there is every reason to believe that banks would have purchased securities from firms other than securities affiliates even in the absence of such affiliates. It is important to recognize that even at the peak of their securities activities in 1929, banks and their affiliates accounted for only 45.5 percent of bond originations.*** This clearly indicates that there were other firms in the market to meet the banks' demand for securities. As one commentator has noted:

> "[A] natural bank demand for marketable debt developed during the 1920s, and it is likely that private investment bankers would gladly have sold into the commercial banking system in the absence of bank securities affiliates. Market forces are too strong for such a profit opportunity *not* to have been exploited during the 1920s. If bank securities affiliates had not been in operation, the banking system would likely have bought similar amounts and similar quality bonds from other purveyors."*

Of course, it is another irony of Glass-Steagall that it had little, if any, impact on the perceived problem of bank "overinvestment." Section 16 permits national and member banks to invest without limit in a range of government securities and permits them to invest in corporate debt securities subject only to regulations promulgated by the Comptroller. The Comptroller's "investment securities" regulations are general and relate broadly to marketability and credit quality. This creates a paradoxical situation in which banks can hold as an investment a 30-year corporate bond that they cannot hold for 30 minutes while underwriting it.

The only respect in which Glass-Steagall even arguably addressed the perceived problem of banks' "overinvestment" in unsound securities was through the prohibition against affiliations between member banks and firms "engaged principally" in underwriting corporate securities. From Glass' perspective, Section 20 attacked the root of the problem by eliminating the securities affiliates that had been most actively involved in underwriting the allegedly unsound securities purchased by the correspondent banks. As discussed above, however, Senator Glass was wrong on two counts: banks had not "overinvested" in unsound securities;

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* Economic Report of the President at 117 (1983) (emphasis supplied).

** M. Friedman & A. Schwartz, p. 5 *supra*, at 244-45.

*** Peach, p. 6 *supra*, at 109.

* Flannery, *An Economic Evaluation of Bank Securities Activities before 1933* in Deregulating Wall Street, 67, 72 (I. Walter ed. 1985) (emphasis in original).

and the securities affiliates had simply responded to a market demand that others would have met in their absence.

Glass-Steagall Was Not A Crucial Part of Congress' Response to the Financial Crisis in 1933

Along with the Securities Act of 1933 and the Securities Exchange Act of 1934, Glass-Steagall is commonly cited as a crucial part of Congress' efforts to prevent a recurrence of the stock market crash and the collapse of the banking system. The fact is that Glass-Steagall was no more indispensable in 1933 than it is today.

Provisions of the Banking Act of 1933 other than the Glass-Steagall provisions addressed more directly, and far more effectively, the problems that had led to the collapse of the banking system. The strengthening of the Federal Reserve Board, the creation of a statutory Federal Open Market Committee, the strengthening of minimum capital requirements for national and member banks and, most importantly, the introduction of federal deposit insurance were far more important than Glass-Steagall to insuring the stability of banks and restoring public confidence in the system as a whole. Friedman and Schwartz have suggested that "[F]ederal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic, and, indeed in our view, the structural change most conducive to monetary stability since state bank note issues were taxed out of existence immediately after the Civil War."* Professor Galbraith has made a similar observation:

> "Federal insurance of bank deposits, even to this day, has not been given full credit for the revolution that it has worked in the nation's banking structure. With this one piece of legislation the fear which operated so efficiently to transmit weakness was dissolved. As a result, one grievous defect of the old system, by which failure begot failure, was cured. Rarely has so much been accomplished by a single law."*

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* M. Friedman & A. Schwartz, p. 5 supra at 434.

With respect to the problems and abuses Congress perceived to be associated with commercial banks' securities activities, it is important to distinguish between those that were common to the securities industry as a whole during the 1920s and those that were peculiar to commercial banks' involvement in the securities markets. The abuses that were generally a problem in the securities industry, such as failures to disclose material facts, high pressure sales tactics and market manipulation, were covered by the Securities Act of 1933 and the Securities Exchange Act of 1934. Banks or their affiliates would be no more likely to engage in those abuses today than securities firms. Moreover, the disclosure requirements and antifraud provisions of the Securities Act of 1933 effectively eliminated the possibility that investors, including correspondent banks, would not be fully informed about the securities they purchased.

Of the problems and abuses perceived by Congress that were peculiar to commercial banks' securities activities, the use of an affiliate to manipulate the price of a bank's own stock was addressed by the Securities Exchange Act of 1934. By authorizing the Federal Reserve Board to regulate the extension of bank credit to purchasers of securities this legislation also reduced the already remote likelihood that banks would make unsound loans to purchasers of securities distributed by their affiliates or have difficulty in insisting upon the maintenance of adequate margins on such loans. Moreover, Section 13 of the Banking Act of 1933 added a new section 23A to the Federal Reserve Act, which restricted extensions of credit by member banks to their affiliates. This new section addressed concerns over the possibility that banks would lend too freely to their securities affiliates. By strictly limiting the loans a bank could make to its securities affiliate, the section also reduced substantially the possibility that depositor confidence in a bank might be shaken by the existence of an unprofitable affiliate. In addition, the provision addressed the fear that an affiliate, in the knowledge that it had access to a bank's resources, would make hazardous investments. Under the terms of the section, the affiliate's access to those resources was limited. Finally, rules exist-

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* J. Galbraith, p. 11 supra, at 196.

ing at the time the Glass-Steagall provisions were passed addressed Congress' concern that affiliations between banks and securities firms might affect adversely the independence with which a bank's trust department would exercise its fiduciary duties. In fact, during the Senate debate in May 1932, Senator Bulkley pointed out that "[i]t is a long-established rule of English and American law that a trustee may not profit by dealing with his trust estate."*

Conclusion

Once the myths about Glass-Steagall have been dispelled, it should be possible to assess objectively and accurately the costs and benefits associated with its provisions. It is interesting to note that by 1935 Senator Glass himself had made such an assessment and had changed his views. In connection with Congress' consideration of the Banking Act of 1935, Glass supported a proposal, which was radical by today's standards, that would have permitted national and member banks (as opposed to their affiliates) to underwrite "investment securities." Glass was concerned about the absence of "underwriting houses" to assist in the recovery of the "heavy-goods industries."**

It is encouraging that this Committee is now undertaking a reexamination of Glass-Steagall and the regulation of the financial services industry. It is no less important today than it was in 1935 to insure that American businesses can raise capital quickly and efficiently. Providing for increased competition in the securities markets would be a significant step toward achieving that goal.

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* 75 Cong. Rec. 9912 (daily ed. May 10, 1932).

** 79 Cong. Rec. 11,827 (daily ed. July 25, 1935). Although this proposal was adopted by the Senate, it was dropped in conference. See S. Rep. No. 1007, 74th Cong., 1st Sess., 16 (1935); H. Rep. No. 1822, 74th Cong., 1st Sess., 53 (1935) (conference report).

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3 Legislative History of the Glass-Steagall Act

EDWARD J. KELLY III

Securities market abuses of the 1920s ultimately precipitated several major pieces of financial legislation, including the Glass-Steagall provisions of the Banking Act of 1933.[1] Adopted in response to the stock market crash, the ensuing depression, and the banking crisis that had culminated in the declaration of a national bank holiday in March 1933, the Act, among other things, provided for federal deposit insurance, strengthened the Federal Reserve System, and expanded branch banking. It also included four provisions that mandated a substantial separation of commercial and investment banking. These provisions have come to be commonly referred to as the Glass-Steagall Act.[2] Section 16[3] restricts the securities activities of national banks, most notably by prohibiting them from underwriting corporate securities. Section 20[4] of the Act supports the thrust of Section 16 by prohibiting member banks from being affiliated with any entity "engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. . . ."[5] Section 32[6] generally prohibits officer, director, or employee interlocks between member banks and individuals or entities "primarily engaged" in activities similar to those described in Section 20. Finally, Section 21[7] makes it unlawful for any person or organization "engaged" in activities similar to those specified in Section 20 to engage "at the same time to any extent whatever" in the business of deposit banking.[8]

As a technical matter, the legislative history of the Glass-Steagall Act extends only from its introduction as a bill at the beginning of the Seventy-third Congress in March 1933 to its enactment into law in June of that year. It is important to recognize, however, that the substance of the Act was the subject of considerable, and virtually uninterrupted, congressional attention beginning in early 1931, with some significant legislative developments dating back to 1929. Senator Carter Glass of Virginia, an influential member of the Senate Committee on Banking and Currency, introduced in June 1930 the first bill to which the origins of the Glass-Steagall Act can be traced. This bill was succeeded by several revised versions in 1932 and 1933. One version

of it actually passed the Senate in January 1933, during the lame-duck session of the Seventy-second Congress. As the depression deepened and the bank failures which had plagued the country since the early 1920s ripened into a full-blown crisis in March 1933, a consensus developed that something had to be done to reform the banking structure. Senator Glass stood ready with proposals that had been in various stages of development for three years and with a theory of banking practice that had some historical legitimacy, even if it had lost its relevance and vitality years before. Glass wanted to separate commercial and investment banking, and the abuses Congress believed were associated with banks' securities activities and the damaged reputation of the financial community provided him with an opportunity to achieve his objective.

BACKGROUND

In considering the legislative history of the Glass-Steagall Act, it is important to review, at least briefly, the history of banking regulation in this country. Historically, commercial and investment banking activities were viewed as inherently incompatible.[9] Commercial banks, which operated mainly with depositors' funds, were expected to confine themselves to making "short-term, self-liquidating loans to finance goods in the process of production and commercial transactions."[10] The provision of long-term capital to corporations by commercial banks was regarded as dangerous business.[11] The theoretical basis of these views was the "real bills" doctrine.[12] This doctrine held that if banks engaged only in the types of transactions described above "the expansion of the bank money [would] be in proportion to any extension in trade that [might] take place or to 'the needs of trade,' and that, when trade contract[ed], bank loans [would] be correspondingly paid off."[13] A closely associated doctrine held that "if only commercial loans [were] made, the currency [would] have a desirable elasticity and the banks [would] at all times be in a liquid position."[14] Because of the influence of these theories, national banks operated for years under a legal regime that restricted their ability to underwrite, or to deal in, investment securities.[15] Even after the Comptroller of the Currency eased these restrictions at the turn of the century, national banks were prohibited from underwriting, or dealing in, corporate stocks.[16]

The restrictive features of federal regulation made it difficult for national banks to compete effectively with private bankers and with state-chartered banks and trust companies that did not operate under similar constraints.[17] In response to these conditions, national banks began to create state-chartered affiliates that could underwrite and deal in corporate securities.[18] Although this development elicited unfavorable congressional comment as early as 1913,[19] neither Congress nor the Comptroller took steps to reverse the trend toward more substantial bank involvement in securities activities.

The securities activities of national banks increased markedly during World War I when the banks played an important role in the marketing of government war bonds.[20] The war bond program had two important effects. It enabled the banks to

develop an efficient distribution network for securities, and it made the public more receptive to purchasing securities.[21]

Although the Comptroller at times expressed concern over the securities activities of national banks,[22] such activities continued during the early 1920s.[23] Later, the Comptroller's attitude toward national bank participation in the securities markets began to change.[24] To some extent, this change in attitude was not a matter of choice. National bank participation in securities underwriting had become a fact of economic life and any attempt to limit these activities would have resulted in defections to the state systems.[25] The Comptroller's adoption of this new attitude culminated in passage of the McFadden Act in 1927.[26] This legislation "reaffirmed" national banks' authority to underwrite certain investment securities and was designed to prevent any further erosion of the national banking system.[27] McFadden was carefully drafted to "reaffirm" national banks' authority to underwrite certain investment securities. The Comptroller initially allowed only bond underwriting, but later approved underwriting of certain equity issues as well.[28]

CONGRESS' CONSIDERATION OF THE GLASS-STEAGALL ACT

Congress' Reaction to the Crash

The stock market crash in October 1929 set the stage for the reimposition of restrictions on the securities activities of commercial banks.[29] There was considerable sentiment that banks' participation in speculative activities had contributed to the crash. In May 1929, five months prior to the crash, Senator King had introduced Senate Resolution 71.[30] This resolution authorized the Senate Committee on Banking and Currency to investigate the Federal Reserve System, with particular attention to banks' involvement in speculative securities activities either through the extension of credit to support such activities or through securities affiliates.[31] In his first annual message to Congress in December 1929, President Hoover recommended that Congress consider the separation of commercial and investment banking as part of a larger study of the entire financial system.[32]

In April 1930, the Senate Committee on Banking and Currency reported to the full Senate a modified version of Senate Resolution 71, which authorized a "complete survey" of the national and Federal Reserve banking systems.[33] The Senate approved the resolution in May 1930.[34] Shortly thereafter, in June, Senator Glass introduced a bill, S. 4723,[35] to which the origins of the Glass-Steagall Act can be traced. Glass described the bill as "merely a tentative measure to which I hope to direct the Senate inquiry into the banking system."[36] Although the bill bore little resemblance to the legislation that ultimately became the Glass-Steagall Act, it did contain a provision somewhat similar to Section 16.[37] The bill also provided for the regulation of securities affiliates by requiring member banks to file reports on each of their affiliates with the federal regulatory authorities. The term *affiliate* was defined broadly to include, among other things, a "finance company, securities company, investment

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trust, or other similar institution" controlled directly or indirectly by a bank "or by the shareholders thereof who own or control a majority of the stock of such bank."[38]

A Vulnerable Banking System

An increasing number of bank failures provided further impetus for congressional action in the banking field. During the years 1921–1929, there had been about 5500 bank failures.[39] Eighty-two percent of the failed banks had been small, state-chartered, rural institutions.[40] But these failures reflected basic flaws in the nation's banking structure. The nation had too many small rural banks that were inadequately supervised, poorly managed, and undercapitalized. Of the banks that failed, 39% had capital of less than $25,000, and 88% had capital of less than $100,000.[41] Seventy-nine percent of the banks that failed during the period had been located in communities with less than 2500 inhabitants, with 39% having been located in towns with less than 500 people.[42] Many of these banks had suffered from the depressed state of staple agriculture.[43] They also had been the victims of improved transportation, most notably the auto, which had put larger, more efficient banks within easy reach of many of their former customers.[44]

Even after the wave of failures during the 1920s, there were still 24,912 separately incorporated unit banks scattered across the country in June 1929.[45] Of these banks, 72% had capital of less than $100,000.[46] It requires little imagination to anticipate the devastating effects of a significant economic downturn on a banking structure that was so fundamentally flawed. Moreover, as the smaller banks failed, it was only a matter of time before larger, more sound banks were likely to feel the pressure, particularly from a loss of depositor confidence.

As one might expect in light of the factors discussed above, the number of bank failures increased substantially during 1930. Although there had been about 650 bank failures in 1929,[47] there was no banking panic immediately following the crash.[48] In late 1930, however, a crisis began to develop. In November 1930, there was a rash of bank failures in Missouri, Indiana, Illinois, Iowa, Arkansas, and North Carolina,[49] with a total of 256 banks failing during the month.[50] Another 352 banks failed in December 1930,[51] bringing the total for the year to about 1350.[52] The failure of the Bank of United States in December 1930, had a particularly adverse effect on depositor confidence.[53] The failure, involving deposits of more than $200 million, was the largest in history at that time.[54] Moreover, many people thought that the bank had a special, official status.[55] The seeds of a full-blown panic, precipitated by a loss of public confidence in the banking system, had been planted.

The failure of the Bank of United States was significant for another reason. Apparently, there was a widespread perception that the bank's securities activities, conducted through a system of affiliates, had been seriously implicated in its failure.[56] In 1931, a subcommittee of the Senate Committee on Banking and Currency stated that

> [t]he significance of bank security affiliates and their operations was known to the public in only a most general way, until the failure of the Bank of United States in December 1930, clearly indicated the disastrous results that could follow upon a flagrant abuse of this device, such as took place in that case.[57]

The subcommittee later observed:

> Activities of affiliates in supporting a bank's own stock or in holding real estate have both been the source of substantial loss in individual cases. Taken as a whole, however, it would appear that the security affiliates of the banks studied in connection with the committee's questionnaire ordinarily engaged in such activities to a moderate extent only. It is well to remember, however, that it was precisely this type of activity, and especially the first mentioned, which brought on the disastrous collapse of the Bank of United States and contributed to several large bank failures elsewhere.[58]

It is clear that the officers of the Bank of United States abused the affiliate system and used affiliates to conduct their personal, and highly speculative, business ventures.[59] It is equally clear, however, that the abuses involved in that case provided little support for restricting banks' securities activities by separating commercial and investment banking. It appears that the affiliates of the Bank of United States were involved in the securities business only to the extent that they were used by the bank's officers to trade in the bank's own stock and to engage in other manipulative activities.[60] One commentator has pointed out that the affiliates of the Bank of United States had been formed to handle the affairs and "illicit promotions" of the bank's officers.[61] He suggests, however, that when the press attributed the bank's failure to abuse of the affiliate system, "the public and many politicians became suspicious of the activities of all commercial bank affiliates."[62] He goes on to state that "when the continued existence of the entire affiliate system was threatened, the close relationship between the two banking functions that had grown up within that system automatically became vulnerable."[63] In politics, the perception is often more important than the underlying reality.

Senate Resolution 71 Hearings

Against this background, a subcommittee of the Senate Committee on Banking and Currency in early 1931 conducted the first major hearings on the subjects ultimately covered by the Glass-Steagall Act.[64] The subcommittee was created under the authority granted by Senate Resolution 71, which, as noted,[65] the Senate had passed in May 1930. The subcommittee was chaired by Senator Glass,[66] who was very much a traditionalist in the area of banking practices. He had been a principal architect of the Federal Reserve Act,[67] which was based on the English system "with the idea of banking liquidity as its controlling motive."[68] In this regard, the Act "was drawn for two purposes: the first that of absolutely preventing the use of bank reserves in speculative lines; the other that of making sure that the loans of the reserve banks were always liquid and based on actual transactions in business."[69]

During the Brokers' Loans Hearings in 1928, Glass stated that the framers of the Federal Reserve Act thought "we should have a system that would meet the require-

ments of legitimate industry and commerce, and not a system that would lend itself to what many of us regard as an unproductive operation of stock and commodity gambling."[70] It is clear that Glass had been concerned with commercial banks' involvement in the securities markets for some time. Glass not only thought commercial banks' securities activities were inconsistent with sound banking practice, but also regarded the banks' use of Federal Reserve credit to support them as a perversion of the Federal Reserve Act.[71] In fact, Glass later identified these activities as a major cause of the depression.[72]

Under Glass' direction, the subcommittee explored the banks' role in the events leading to the stock market crash and to the increasing number of bank failures. In this regard, the hearings focused on banks' participation in "speculative" securities activities through the extension of credit to support such activities, through investment practices, and through securities affiliates.[73] In an appendix to the hearings, the subcommittee suggested that

> [t]he experience of the past 10 years lends spectacular confirmation to the view that the more intensive participation by commercial banks in the capital market exaggerates financial and business fluctuations and undermines the stability of the economic organization of the country.[74]

In a section of the appendix devoted to securities affiliates, the subcommittee stated that such affiliates were engaged in a variety of activities, ranging from acting as a real estate holding company to underwriting securities.[75]

Referring generally to securities affiliates, the subcommittee identified a number of ways in which the operations of such an affiliate could affect adversely the position of a bank:

> (1) The security affiliate may borrow money from the parent bank[76]
>
> (2) The affiliate may sell securities to the bank or another of its affiliates under repurchase agreements, or vice versa.
>
> (3) The bank is closely connected in the public mind with its affiliates, and should the latter suffer large losses it is practically unthinkable that they would be allowed to fail. Instead, the bank would normally support it by additional loans or other aid, thus becoming more deeply involved itself. The knowledge that the affiliate has suffered large losses may in itself be sufficient to cause unfavorable rumors, however unjustified, to spread about the bank.
>
> (4) The bank, to relieve the affiliate of excess holdings, may purchase securities from it.
>
> (5) The bank may lend much more freely to customers on issues sponsored by the security affiliate, in order to facilitate their distribution, than it would otherwise do. Also, it may prove more difficult to insist upon the maintenance of adequate margins on these security loans than on other such advances, in view of the fact that customers are encouraged to make loans by the bank's own affiliate.

> (6) The good will of the bank with its depositors may be adversely affected to a serious degree when the latter suffer substantial losses on security issues purchased from the affiliate. Because of the tendency of the selling organization of the affiliate to consider the bank's depositors as its preferred list of sales prospects, this condition may become an important handicap to a bank during a major period of security market deflation.
>
> (7) Operations by the affiliate in the market for the bank's own stock may cause undesirably wide fluctuations in the latter. Also, efforts made in some cases to push the sale of the bank's stock through the affiliate to depositors of the institution hurts the position of the bank when its shares suffer a major market decline subsequently.
>
> (8) Wide variations in the net asset value, earning power, and dividend-paying ability of security affiliates tend to make bank stock price fluctuations much greater than would otherwise be the case.
>
> (9) The existence of the affiliates may induce the bank to make unwise commitments, in the knowledge that in case of need they can be shifted to the affiliates, and thus be removed from the bank's condition statement.
>
> (10) Knowing its access to the resources of the bank in case of need, security affiliates in their turn may tend to assume various commitments less cautiously than do private investment banking houses.
>
> (11) In the case of a trust company or a bank with a trust department, the possession of a security affiliate may adversely affect the independence with which fiduciary activities are exercised.''[77]

Continued Deterioration of the Banking System

No immediate action was taken in response to these hearings. The banking situation, however, continued to deteriorate throughout 1931. After a lull in early 1931, a ''spate of runs began in March . . . and reached a high point in June, attacking the Midwest, Pennsylvania, and New York in particular, intensifying with the collapse of the major European central banks.''[78] The situation was aggravated further by England's abandonment of the gold standard in September.[79] In view of steadily eroding depositor confidence, banks moved to achieve greater liquidity so that they could meet renewed runs. One commentator has stated that ''by the end of 1931, bankers had called in loans, converted to cash, and pursued deflationary policies to the point where they felt themselves caught in the relentless economizing.''[80] There were 2290 bank failures during 1931.[81]

Renewed Congressional Activity

In January 1932, Senator Glass introduced S. 3215.[82] This bill was much more extensive and severe in its treatment of commercial banks' securities activities than S. 4723, the bill Glass had introduced in mid-1930.[83] S. 3215 was designed to separate securities affiliates from commercial banks.[84] It also contained provisions similar to

those that became Sections 16 and 32 of the Glass-Steagall Act.[85] Moreover, S. 3215 included a provision that can be viewed as a forerunner of Section 21 of the Glass-Steagall Act.[86] That provision prohibited any ''corporation engaged in commerce as defined in this Act'' from depositing its funds ''with any individual, private banker, or banking association or trust company, except banking associations incorporated under the laws of the United States or some of the States or Territories thereof.''[87]

Professor Willis, who, as noted,[88] had served as special counsel to the Senate Resolution 71 subcommittee, later suggested that this provision was designed primarily to prevent ''the siphoning off of deposits in incorporated banks into private institutions which would, as in the past, feed them into stock exchange loans.''[89] It is noteworthy that the Pujo Committee had stated:

> Interstate corporations should not be permitted to deposit their funds with unsupervised, unregulated, private bankers who do not disclose their resources or liabilities, who keep no reserve and are free to invest their depositors' money as they see fit.[90]

Moreover, at the Senate Resolution 71 hearings, the New York Superintendent of Banks had submitted a report to the subcommittee that had been filed with the Governor of New York, which recommended legislation to require private bankers to discontinue accepting deposits and to liquidate their deposit liabilities.[91]

The financial community was adamantly opposed to S. 3215. Two commentators have stated that ''[b]ankers' associations, individual financiers and chambers of commerce joined in condemning [S. 3215] as a vicious bill and an insuperable bar to economic recovery.''[92] The press reported that the Treasury Department also was opposed to the bill and that there was sentiment in support of conducting hearings on the legislation.[93] In early February, Glass made a speech on the Senate floor about the banking community's opposition to his bill.[94]

Senator Glass revised S. 3215 and introduced a new bill, S. 4115, in March 1932.[95] S. 4115 reflected the thrust of S. 3215,[96] but did not contain some provisions of the earlier bill, including the section identified above as a predecessor of Section 21 of the Glass-Steagall Act.

Hearings on S. 4115

In late March 1932, the Senate Committee on Banking and Currency held hearings on S. 4115.[97] At the hearings, representatives of the banking community objected to the bill on the ground that it was extremely deflationary.[98] In addition, the Federal Reserve Bank of New York characterized as ''unwise'' the provisions calling for a divorce of ''the banking system and the capital market.''[99] Governor George L. Harrison stated that these provisions would ''disturb the mechanism of the capital market, the free functioning of which is now so important to a recovery from existing business conditions.''[100]

Eugene Meyer testified for the Federal Reserve Board.[101] He stated that ''affili-

ations between member banks and security companies have contributed to undesirable banking developments.''[102] But Meyer went on to state:

> There are difficulties . . . in the way of accomplishing a complete divorce of member banks from their affiliates arising from the fact that a law intended for that purpose is likely to be susceptible of evasion or else to apply to many cases to which it is not intended to apply. Therefore, the board is not prepared at this time to make a definite recommendation, but submits, for the consideration of the Committee on Banking and Currency, a [provision] which is designed to provide for the divorce of security affiliates from member banks after three years . . . .[103]

Meyer explained the tentative nature of the Board's proposal by citing ''the absence of full information on the subject.''[104] He stated that the Board had discussed the idea of deferring the separation issue pending further study.[105] Meyer noted that

> [the Board did not feel], in the absence of more definite information, any too great confidence in any recommendation that [it] or anyone else could make. But this is a suggestion for your consideration, which was the best we could evolve in the board with the assistance of our experts.[106]

Senate's Consideration of S. 4412

Following the hearings, Glass again revised his bill and introduced S. 4412 on April 18, 1932.[107] S. 4412 was reported by the Committee to the full Senate on the same day.[108] This bill, as reported, included the new section suggested by Governor Meyer.[109] The report accompanying S. 4412 offered the following assessment of the condition of member banks:

> The outstanding development in the commercial banking system during the prepanic period was the appearance of excessive security loans, and of overinvestment in securities of all kinds. The effects of this situation in changing the whole character of the banking problem can hardly be overemphasized. National banks were never intended to undertake investment banking business on a large scale, but the whole tenor of legislation and administrative rulings concerning them has been away from recognition of such a growth in the direction of investment banking, as legitimate. Nevertheless it has continued, and a very fruitful cause of bank failures, especially within the past two years, has been the fact that the funds of various institutions have been so extensively ''tied up'' in long-term investments. The growth of the investment portfolio of the bank itself has been greatly emphasized in importance by the organization of allied or affiliated companies under State laws, through which ever more extensive advances and investments in the security market could be made.[110]

The report was very critical of securities affiliates. It stated:

> There seems to be no doubt anywhere that a large factor in the overdevelopment of security loans, and in the dangerous use of the resources of bank depositors for the

> purpose of making speculative profits and incurring the danger of hazardous losses, has been furnished by perversions of the national banking and State banking laws, and that as a result, machinery has been created which tends towards danger in several directions.
>
> (a) The greatest of such dangers is seen in the growth of ''bank affiliates'' which devote themselves in many cases to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock often largely with the resources of the parent bank. This situation was never contemplated by the national banking act, and it would, therefore, appear that the affiliate system calls for the establishment of some legislative provisions designed to deal with the situation. It has been suggested from many quarters that the affiliate system be simply ''abolished.'' This suggestion has much authority behind it, but, in addition to the manifest difficulty of enforcement, owing to the existence of well-known subterfuges to maintain control, there remains the question whether it would be of much real service so long as State legislation permits the growth of affiliates in connection with State banks and trust companies. The committee has, therefore, determined to present proposed legislation aimed at the following objects:
>
> (1) To separate as far as possible national and member banks from affiliates of all kinds.
>
> (2) To limit the amount of advances or loans which can be obtained by affiliates from the parent institutions with which they are connected.
>
> (3) To install a satisfactory examination of affiliates, working simultaneously with the present system of examination applicable to the parent banks.[111]

S. 4412 was debated on the Senate floor in May 1932. During the debate, Senator Glass mentioned the banking community's continued opposition to the separation of securities affiliates from commercial banks,[112] but suggested that

> [t]he committee ascertained in a more or less definite way—we think quite a definite way—that one of the greatest contributions to the unprecedented disaster which has caused this almost incurable depression was made by these bank affiliates.[113]

Glass stated that the affiliates ''sent out their high-pressure salesman and literally filled the bank portfolios of this country with these investment securities.''[114] At one point he asserted that

> the great banks in the money centers choked the portfolios of their correspondent banks from Maine to California with utterly worthless investment securities, nearly eight billions of them being the investment securities tottering South American republics and other foreign countries.[115]

Senator Walcott, who was a member of the Senate Committee on Banking and Currency, stressed that the affiliates were engaged in speculative activities ''quite contrary to legitimate commercial banking.''[116] Walcott also attributed the unprecedented level of bank failures to the purchase by small correspondent banks of ''the very securities that the larger banks have forced upon them.''[117] Senator Bulkley, who had been asked by Glass to address the provisions of the bill relating to securities affiliates and investment banking, described the bill as a prophylactic measure designed ''to protect the operations of the banking system itself, and to protect the depositors and customers of the banks.''[118] To this end, the bill prohibited national and state member banks from carrying on the investment security business either directly, or through affiliates.[119] Bulkley cited a range of problems arising from banks' relationships with securities affiliates.[120] The problems discussed by Bulkley were similar to those reviewed by the subcommittee in the Appendix to the Senate Resolution 71 hearings.[121] The thrust of Bulkley's comments is perhaps best captured by the following statement:

> [T]he banker who has nothing to sell to his depositors is much better qualified to advise disinterestedly and to regard diligently the safety of depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment on which the bank is to receive an originating profit or an underwriting profit or a distribution profit or a trading profit or any combination of such profits.[122]

Although Glass tried repeatedly to persuade the Senate to take final action on S. 4412, the Senate did not act before the end of the session.[123]

The election of President Roosevelt in November 1932 provided additional momentum for the adoption of Glass' proposals. Although the Democratic Party platform had not specifically endorsed Glass' bill, it had called for the separation of securities affiliates from commercial banks and for further restrictions on the use of the Federal Reserve facilities for speculative purposes.[124] The President-elect also had endorsed such action during the campaign.[125] Armed with this new support, Glass finally persuaded the Senate to act on S. 4412 in January 1933, during the lame-duck session of the Seventy-second Congress. Following a filibuster by Senator Long prompted by his opposition to the bill's branch banking provisions,[126] the Senate passed S. 4412 by a vote of 54 to 9 on January 25, 1933.[127]

Glass' statements during the debate were similar to those he had made in June. He stated, among other things, that he wanted ''to make it impossible hereafter to have the portfolios of commercial banks filled with useless speculative securities, so that when stringency comes upon the country these banks may not respond to the requirements of commerce.''[128] Glass suggested that this was the problem ''with the country today, and it is because the bill would avert a repetition of that disaster that intense and bitter opposition has been organized against it.''[129] Glass was willing, however, to accede to the still-vital opposition on the part of the banking community to the extent that he agreed to amendments to delay the effect of the legislation, and in particular to increase from three to five years the period for separation of securities affiliates from commercial banks.[130] Despite the overwhelming vote in the Senate, Glass was thwarted again when the House failed to act on Section 4412 before the end of the Seventy-second Congress.[131]

Important Events in Early 1933

Stock Exchange Practices Hearings. In the early months of 1933, several events helped Glass considerably in his efforts to secure enactment of his proposals. First, the Pecora hearings on stock exchange practices focused public attention on objectionable financial practices[132] and, in particular, on the abuses involved in the relationship between National City Bank and its securities affiliate, the National City Company. The hearings revealed, among other things, that National City Bank and its affiliate repeatedly had failed to disclose material facts to investors, the affiliate had engaged in high-pressure sales tactics; the affiliate had traded in the stock of the bank and participated in a range of manipulative activities, the bank had provided the affiliate with customers, and the bank had used the affiliate to relieve the bank of bad loans to the detriment of shareholders.[133]

The Banking Crisis. The high incidence of bank failures that had plagued the nation for years finally gave rise to a full-blown panic in late 1932 and early 1933. This panic culminated in President Roosevelt's declaration of a bank holiday in March 1933.[134]

During 1932, about 1450 banks had failed.[135] The majority of failures still had been occurring among small banks. For the year ending October 31, 1932, 84.5% of the banks that had failed had been institutions with capital of less than $100,000.[136] The rash of failures among small banks, however, had begun to put pressure on the larger ones. The surviving banks' efforts to achieve greater liquidity had only aggravated the situation, because as they had converted assets into cash the market value of their remaining assets had become further depressed. The situation had been further aggravated by the general economic downturn that had hit the country. Between 1929 and 1933, ''net national product fell by more than one-half in current prices, more than one-third in constant prices, and more than one-third in monthly wholesale prices.''[137] By the end of 1932, banking systems in some states had begun to fail entirely.[138]

These developments quickly led to a total erosion of depositor confidence[139] which, in turn, led to hoarding and to renewed runs on existing banks. The public's currency holdings increased about 16% between the end of 1932 and February 1933.[140] Moreover, as two commentators have pointed out, ''any runs on banks for whatever reason became to some extent self-justifying, whatever the quality of assets held by banks.''[141] In January 1933, 237 banks failed, followed by 148 failures in February.[142] These numbers, however, do not reflect the increasing number of states that had been forced to declare bank holidays. Iowa, Louisiana, and, most important, Michigan, had declared bank holidays by mid-February.[143] These developments put intense pressure on the New York banks, which were faced not only with demands for cash from their local depositors, but also with withdrawals by the interior banks.[144] By early March, holidays had been declared in about half the states, including New York and Illinois.[145] Although President Roosevelt's declaration of a national bank holiday and Congress' enactment of emergency banking legislation in early March stabilized the situation and permitted the reopening of most of the surviving banks,[146] a consensus had developed regarding the need for reform of the banking structure.

Aldrich's Announcement. Finally, Winthrop Aldrich, the new chairman of the Chase National Bank, announced in March that he supported a separation of commercial and investment banking and that the Chase would sever its investment affiliate.[147] In making his announcement, Aldrich commended the National City Bank for its recent decision to drop its securities affiliate, and went on to propose several major reforms designed to effect a separation of commercial and investment banking.[148] Among these proposals was one to prohibit private bankers from receiving deposits unless they agreed to submit to the same regulation and disclosure requirements as commercial banks.[149] Aldrich suggested that "no corporation or partnership dealing in securities should be permitted to take deposits even under regulation."[150]

One commentator has suggested that the combination of the Pecora hearings and Aldrich's announcement broke the back of the banking community's opposition to the Glass legislation.[151] She notes that other bankers followed Aldrich's lead and that after the spring of 1933 there was no real opposition to separating commercial and investment banking.[152] In this regard, it is also noteworthy that in March 1933,

> [m]any affiliates were in process of liquidation, or had been previously dissolved, either because final passage of the Glass bill was anticipated or because banks welcomed the opportunity to rid themselves of affiliates which they had thought necessary or highly desirable during the twenties.[153]

The investment banking business had dropped off substantially, and "no one was prepared to predict how soon, if ever again, this commercial banking sideline might be able to pay its own way."[154]

The Glass-Steagall Act Becomes Law

At the beginning of the Seventy-third Congress in March 1933, Glass introduced S. 245, which largely reflected the changes that had been made in S. 4412 during the Senate debate in January.[155] In May, S. 245 was replaced by S. 1631.[156] S. 1631 included for the first time a section basically identical to Section 21 of the Glass-Steagall Act.[157] The introduction of the bill also marked the reappearance of a section very similar to Section 32.[158] At this point, provisions substantially similar to all four sections of the Glass-Steagall Act were included in the bill.[159]

The Senate Committee on Banking and Currency reported S. 1631 to the full Senate on May 15, 1933.[160] The report accompanying the bill was similar to the one that had accompanied S. 4412, and, in fact, contained some language identical to language in the earlier report.[161]

The Senate debated S. 1631 in late May 1933. The statements of the bill's proponents were not much different from the ones they had made on prior occasions. At one point, for example, Senator Glass stated:

> [T]hese affiliates, I repeat, were the most unscrupulous contributors, next to the debauch of the New York Stock Exchange, to the financial catastrophe which visited this country and was mainly responsible for the depression under which we have been suffering since. They ought to be separated, and they ought speedily to be separated, from the parent banks, and in this bill we have done that.[162]

The debate, however, is noteworthy in several respects. For the first time, Glass discussed the provision that was to become Section 21 of the Glass-Steagall Act. Glass described this provision as "rather controversial" and stated that he had included it "in the original so-called 'Glass bill.'"[163] He said that the provision had been eliminated in succeeding drafts in response to "the bitter hostility of the large private banking interests of the country," which Glass feared might be sufficient to kill the bill.[164] Glass noted, however, that in this bill "the large private banks, whose principal business is an investment business," were prohibited "from receiving deposits."[165] Later, Senator Bulkley fought off an amendment to Section 21 on the ground that it "would materially change one of the most important principles in the bill."[166] In this regard, both Bulkley and Glass described the provision as "vital."[167] Finally, Bulkley offered an amendment to change the words "engaged principally" which then appeared in Section 21 to "engaged."[168] Bulkley stated:

> It has become apparent that at least some of the great investment houses are engaged in so many forms of business that there is some doubt as to whether the investment business is the principal one. Therefore this word must be eliminated in order to make sure that we will accomplish a separation of investment and deposit banking.[169]

The amendment was adopted[170] and the Senate later passed the bill without a record vote.[171]

Following the House-Senate conference on the legislation, which for present purposes basically resulted in adoption of the Senate bill,[172] the Senate and House both approved the conference report on June 13.[173] The legislation was signed into law on June 16, 1933.[174]

CONCLUSION

The legislative history of the Glass-Steagall Act is the story of a theory carried along by events. Standing alone, Senator Glass' theory of sound banking practice was not sufficiently persuasive to secure enactment of the divorce provisions. The theory needed the support provided by the collapse of the banking system and the damaged reputation of the financial community. In the next chapter, Professor Flannery suggests that Congress misperceived the causes of the depression and the banking crisis and grossly overestimated the extent to which commercial banks' securities activities were responsible for these events. In this light, the wisdom of retaining the Glass-Steagall Act should be reviewed.

NOTES

[1] 48 Stat. 162 (codified in scattered sections of 12 U.S.C.).

[2] *See* Natter, *The Glass-Steagall Act: Separation of Commercial and Investment Banking*, in, HOUSE COMM. ON BANKING, FINANCE, AND URBAN AFFAIRS, FORMATION AND POWERS OF NATIONAL BANKING

ASSOCIATIONS—A LEGAL PRIMER 4–9 (Comm. Print 98-4 1983); Clark and Saunders, *Judicial Interpretation of Glass-Steagall: The Need for Legislative Action*, 97 BANKING L. J. 721, 725 (1980).

[3] 12 U.S.C. Section 24. Section 16 states in relevant part:

> [A] national banking association . . . shall have power—To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security; and by obtaining, issuing and circulating notes according to the provisions of this chapter. The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: Provided, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund, except that this limitation shall not require any association to dispose of any securities lawfully held by it on August 23, 1935. As used in this section the term "investment securities" shall mean marketable obligations, evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof.

Section 5(c) of the Banking Act of 1933 applied the restrictions of Section 16 to member banks. *See* 12 U.S.C. Section 335.

[4] 12 U.S.C. Section 377. Section 20 states in relevant part:

> After one year from June 16, 1933, no member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities.

[5] *Id.*

[6] 12 U.S.C. Section 78. Section 32 states in relevant part:

> No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.

[7] 12 U.S.C. Section 378. Section 21 states in relevant part:

> After the expiration of one year after June 16, 1933, it shall be unlawful—(1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the

> securities: *Provided*, That the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of Section 24 of this title: *Provided further*, That nothing in this paragraph shall be construed as affecting in any way such right as any bank, banking association, savings bank, trust company, or other banking institution, may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate.

[8] The variations in wording among Section 20 ("engaged principally"), Section 21 ("engaged"), and Section 32 ("primarily engaged") are significant. The Supreme Court has interpreted "primarily engaged" in Section 32 to mean "substantial." Board of Governors v. Agnew, 329 U.S. 441, 446 (1947). This is a more stringent standard for determining violations of the Act than that embodied in Section 20. *See id.*, at 447–448, but it is less stringent than the one embodied in Section 21. See Board of Governors, FRS v. Investment Company Inst., 450 U.S. 46, 60–61 n.26 (1981).

[9] *See* U.S. Department of Treasury, Public Policy Aspects of Bank Securities Activities 4 (1975) [hereinafter Treasury Paper]; Golembe Associates, *Commercial Banking and the Glass-Steagall Act* 20–21 (1982) (prepared for the American Bankers Association) [hereinafter *Golembe Paper*]; Peach, *The Security Affiliates of National Banks*, in Wall Street and the Security Markets 111 (V. Carosso ed.) (1975); Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 Banking L. J. 483, 486 (1971). *See also Operation of the National and Federal Reserve Banking Systems: Hearings Pursuant to S. Res. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 71st Cong., 3d Sess. 999, 1030, 1052 (1931) [hereinafter *S. Res. 71 Hearings*]. This view was drawn largely from the English, as opposed to the German, system. *See* Treasury Paper, *supra*, at A-2; *Golembe Paper*, *supra*, at 20–21; Perkins, *supra*, at 485–486; M. Nadler and J. Bogen, The Banking Crisis 36 (1933). During the Senate debate on the Glass bill in 1932, Senator Bulkley explicitly endorsed the English practice. *See* 75 Cong. Rec. 9911 (daily ed. May 10, 1932) (statement of Sen. Bulkley).

[10] Treasury Paper, note 9 *supra*, at 8.

[11] *See* Peach, note 9 *supra*, at 111; Perkins, note 9 *supra*, at 485–486. *See also Stock Exchange Practices: Hearings Before the Senate Comm. on Banking and Currency on S. Res. 84 and S. Res. 56*, 73d Cong., 2d Sess. 3979 (statement of Winthrop W. Aldrich, President, Chase National Bank).

[12] *See Golembe Paper*, note 9 *supra*, at 21–22; Perkins, note 9 *supra*, at 501–502.

[13] *See* L. Mints, A History of Banking Theory 9 (1945). Mints suggests that "banking legislation has been too much controlled, in the United States at any rate, by the belief that a restriction of the banks to the making of loans for bona fide commercial purposes will automatically provide for all needed variations in the means of payment." *Id.*, at 5. He states: "This belief, which I have called the 'real-bills doctrine,' is utterly subversive of any rational attack on the problem of monetary policy. If there is a central theme to what I have written, it is that this doctrine is unsound in all its aspects." *Id.*

[14] *Id.*, at 9.

[15] *See* Treasury Paper, note 9 *supra*, at A-2–A-3; Perkins, note 9 *supra*, at 486–490.

[16] *See* Treasury Paper, note 9 *supra*, at A-4–A5; Peach, note 9 *supra*, at 50–51.

[17] *See* Treasury Paper, note 9 *supra*, at A-4–A-5; Perkins, note 9 *supra*, at 486–490. The adherence to the English system broke down more quickly in the state banking systems due to the rise of the trust companies after the Civil War. In response to this development, state banks sought, and were granted, more liberal charters. *Id.*

The *Golembe Paper* suggests that the English system never was followed strictly in this country either at the federal or the state level. *See Golembe Paper*, note 9 *supra*, at 25–28. Among other things, the paper points out that commercial banks have been involved from their inception in providing long-term credit to business and government. *Id.*, at 25–29. *See also* M. Nadler & J. Bogen, note 9 *supra*, at 37.

One commentator has pointed out that the English merchant banks combined depository, lending, brokerage, and investment functions, and were widely copied on the continent and in the United States. *See* Asher, "Glass-Steagall: A Fresh Look," *ABA Banking Journal* 62 (Feb. 1981). He suggests that Senator Glass and other proponents of the "English system" were "fooled" by the merchant banks' decision not to deal with the rising middle class. To fill the gap, "the British clearing banks came into existence." They took deposits and made loans to the general public. Eventually, they became larger than the merchant banks. The merchant banks, however, continued to take deposits from business and the wealthy, to make loans to these groups, and to engage in underwriting and brokerage activities. Asher states that "there was never a split in the British system between banking and investment—not in law, not in practice." *Id.*

[18] *See* Treasury Paper, note 9 *supra*, at A-5; Perkins, note 9 *supra*, at 486–490; Peach, note 9 *supra*, at 51–52, 59. The First National Bank in New York City organized the first securities affiliate on record in 1908. *See S. Res. 71 Hearings*, note 9 *supra*, at 1052. Perkins states that the First National Bank had been engaged in the securities business for many years prior to 1908. Perkins, note 9 *supra*, at 489. It formed an affiliate in response to the federal government's criticism of the bank's buying and selling of common stock. *Id.*

[19] H.R. Rep. No. 1593, 62d Cong., 3d Sess. 164 (1913) [hereinafter Pujo Report]. The Pujo Committee, which was created to investigate the concentration of control of money and credit, stated in its report:

> The national banks of the great cities are exceeding their charter powers in the character of the business they are conducting and from which their principal revenues are derived. They are acting as promoters, underwriters, and houses of issue for the securities of railroad and industrial corporations. Their activities have extended even into foreign countries and to highly speculative and undeveloped enterprises, through the thin disguise of the so-called security companies that are attached to them. . . . *Id.*, at 151.

The committee also stated:

> [We are] of opinion that national banks should not be permitted to become inseparably tied together with security-holding companies in an identity of ownership and management. These holding companies have unlimited powers to buy and sell and speculate in stocks. It is unsafe for banks to be united with them in interest or management. The temptation would be great at times to use the bank's funds to finance the speculative operations of the holding company. *Id.*, at 155.

The committee went on to recommend that [t]he stockholders of a national bank should be expressly prohibited from becoming associated as stockholders in any other corporation under agreements or arrangements assuring that the stock of such other corporation shall always be owned by the same persons or substantially the same persons who own the stock of the bank or that the management shall be substantially the same. *Id.*, at 164.

The Committee also recommended that:

> [n]ational banks should be prohibited from directly or indirectly engaging in any promotion, guaranty, or underwriting, involving the purchase, sale, public offering, or issue, or other disposition of the securities of any corporation. *Id.*

[20] *See* Treasury Paper, note 9 *supra*, at A-6; Perkins, note 9 *supra*, at 491.

[21] *See* Treasury Paper, note 9 *supra*, at A-6; J. Brooks, Once in Golconda 5 (1970); R. Patterson, The Great Boom and Panic 9 (1965); Perkins, note 9 *supra*, at 491. Perkins states that "[m]any banks and trust companies either expanded their bond departments or formed security affiliates to handle [the war bond] business." *Id.*

[22] *See S. Res. 71 Hearings*, note 9 *supra*, at 1067–1068 (citing 1920 Annual Report of the Comptroller of the Currency); Peach, note 9 *supra*, at 148–150.

[23] *See* M. Friedman & A. Schwartz, A Monetary History of the United States 1867–1960 240, 244–245 (1963).

[24] *See* Treasury Paper, note 9 *supra*, at A-8; Peach, note 9 *supra*, at 150. Perkins points out that during the war years "in an effort to strengthen the still experimental Federal Reserve System, state banks and trust companies were allowed to enter the new system without having to give up any of the corporate privileges granted to them by state law." Perkins, note 9 *supra*, at 491. Perkins states:

> The result of this decision by the Federal Reserve Board in Washington was to recognize formally the right of at least one class of member banks to engage in investment banking. Any national bank that had heretofore pondered the ultimate legality of the security affiliate system interpreted this move as a go-ahead signal to pursue profits in the investment banking field. *Id.*

[25] *See* Treasury Paper, note 9 *supra*, at A-8. *See also* M. Friedman & A. Schwartz, note 23 *supra*, at 245; C. Bremer, American Bank Failures 95–96 (1935). Apparently, the concern was not so much over the number of member banks, but rather over the comparison between the assets held by state and national banks. The assets of state banks were increasing, whereas those of national banks were declining. The Comptroller believed that this threatened the federal government's control over credit. *See* Treasury Paper, note 9 *supra*, at A-8.

[26] *See id.*

[27] *See id.*; *Golembe Paper*, note 9 *supra*, at 35; Peach, note 9 *supra*, at 150.

[28] *See* Perkins, note 9 *supra*, at 496. Although the Comptroller initially restricted the "approved list" under the McFadden Act to debt securities, he later expanded it to include equity securities. *Id.*, at 496 n.27. *See also* Treasury Paper, note 9 *supra*, at A-9.

[29] *See* V. Carosso, Investment Banking in America 368 (1970); Treasury Paper, note 9 *supra*, at A-16; Natter, note 2 *supra*, at 4–6; Peach, note 9 *supra*, at 14–15.

[30] S. Res. 71, 71st Cong., 1st Sess., 71 Cong. Rec. 1830 (daily ed. May 24, 1929).

[31] *Id.*

[32] *See* V. Carosso, note 29 *supra*, at 368.

[33] *See* S. Rep. No. 493, 71st Cong., 2d Sess. (1930).

[34] 72 Cong. Rec. 8335 (daily ed. May 5, 1930).

[35] S. 4723, 71st Cong., 2d Sess., 72 Cong. Rec. 10,973 (daily ed. June 17, 1930).

[36] 72 Cong. Rec. 10,973 (daily ed. June 17, 1930) (statement of Sen. Glass).

[37] S. 4723, note 35 *supra*, at sec. 2.

[38] *Id.*, at secs. 7, 9.

[39] *See* 77 Cong. Rec. 3949 (daily ed. May 22, 1933) (statement of Rep. Bacon); S. Kennedy, The Banking Crisis of 1933 16 (1973); C. Bremer, note 25 *supra*, at 12; M. Nadler & J. Bogen, note 9 *supra*, at 24; N.Y. Times, May 29, 1932, sec. 9, at 1.

[40] S. Kennedy, note 39 *supra*, at 205.

[41] C. Bremer, note 25 *supra*, at 47.

[42] *Id.*

[43] *See S. Res. 71 Hearings*, note 9 *supra*, at 3–7 (statement of J. W. Pole, Comptroller of the Currency); S. Kennedy, note 39 *supra*, at 16; M. Friedman & A. Schwartz, note 23 *supra*, at 240, 249; C. Bremer, note 25 *supra*, at 57. During 1921–1929, "about 70 per cent of all bank failures . . . occurred in twelve agricultural states, of which 41 per cent consisted of banks situated in seven Western grain states." H. P. Willis & J. Chapman, The Banking Situation 315 (1934). *See also* 77 Cong. Rec. 3949 (daily ed. May 22, 1933) (statement of Rep. Bacon); 75 Cong. Rec. 9897 (daily ed. May 10, 1932) (statement of Sen. Glass):

> "Two fundamental causes are at the root of the small bank failures—lack of diversity and necessarily lack of earning power. Most of the small banks are what may be termed, as I have stated, 1-crop or 1-enterprise banks. Where the loans of a bank are made to a community which depends on cotton, and cotton prices are low, or a crop fails, the bank is unable to stand the shock, and the amount of losses can not be absorbed, due to the lack of earnings, and it eventually fails. And so if it is in a tobacco community, so if it is in a coal-mining section."

[44] *See S. Res. 71 Hearings*, note 9 *supra*, at 7 (statement of J. W. Pole, Comptroller of the Currency); M. Friedman & A. Schwartz, note 23 *supra*, at 240.

[45] M. Nadler & J. Bogen, note 9 *supra*, at 35.

[46] *Id.*

[47] 77 Cong. Rec. 3949 (daily ed. May 22, 1933) (statement of Rep. Bacon); S. Kennedy, note 39 *supra*, at 19.

[48] *Id.*

[49] *Id.* *See also* M. Friedman & A. Schwartz, note 23 *supra*, at 308.

The CHAIRMAN. Thank you very much, Mr. Kelly. I want to thank all of you.

Mr. Ritchie, Senator Carter Glass was the moving force behind the separation of investment banking and commercial banking, as you pointed out. He believed there was a sharp conflict between acting as a lender and as a securities underwriter. In particular, he believed the banks with securities affiliates often used their affiliates to underwrite securities where the proceeds were used to bail out bad loans made by the bank.

These dubious securities, according to Senator Glass, were then sold to unsuspecting customers of the bank, including many of their smaller correspondent banks. Losses on these securities helped to bring down many banks during the Great Depression of 1929–1933.

What historical evidence is there to support Senator Glass?

Mr. RITCHIE. Most of the evidence is the testimony that came out of the Pecora investigation, some of which took place before Glass-Steagall was passed and some of which took place after it during 1933. Both the testimony of Charles Mitchell and the events that took place with the National City Co. and its bailing out of its bad loans, such as the sugar industry loans, or the evidence that Albert Wiggins of the Chase Bank gave about short selling of its own bank's stocks and other manipulations of his stocks; evidence that came out of the company of Kuhn, Loeb & Co., a private bank which admitted to some of these activities; Dillon, Read & Co. was also called to testify.

One by one, Pecora brought out the leading bankers of the country, the most reputable—not the small——

The CHAIRMAN. Mr. Kelly, what is your reaction to the allegation arising out of the Pecora hearings that National City Bank used its securities affiliate to "bail out" bad loans to the Cuban sugar industry? This transaction has been mentioned today by Mr. Ritchie and is frequently cited by opponents of expanded securities powers for bank holding companies.

Mr. KELLY. Mr. Chairman, I think the ultimate effect, and implications, of the transaction involving National City Bank, National City Co. and holding company for Cuban sugar interests are commonly misunderstood. A careful analysis of the transaction reveals that it did not harm National City Bank, the shareholders of the bank, or the investing public. In fact, the transaction strengthened the bank and, therefore, benefited depositors. As Charles Mitchell explained at the time, the transaction permitted the National City organization to covert a doubtful loan held by the bank into an equity investment by National City Co., the bank's securities affiliate. Since the same shareholders owned the bank and the securities affiliate, it was a matter of indifference to them which entity within the group held an asset related to the Cuban sugar industry. Moreover, it is important to recognize that the stock purchased by the securities affiliate was held by the securities affiliate and not resold to the public. This was not a case in which unsound loans held by a bank were packaged and sold to the public by the bank's securities affiliate. As far as the National City organization was concerned, there was no "bail out" of bad loans. The nature of the asset held by the organization was simply changed—a change which strengthened the bank.

The CHAIRMAN. What is the documentation of the number of banks that failed for this reason. Do you have any knowledge or can you refer us to any studies that have traced the failures actually to this activity?

Mr. RITCHIE. No, I can't, Senator.

The CHAIRMAN. Can you, Mr. Perkins?

Mr. PERKINS. Yes, sir. Senator, I didn't write this article but it was published by Eugene White of the Economics Department at Rutgers University; he made an analysis of what actually happened.

The CHAIRMAN. When was that written?

Mr. PERKINS. It was written in 1986. It's published in a journal called "Explorations in Economic History." I read it before I came here, and basically he came to the conclusion that very few banks really did fail as a result of these activities, just miniscule. Despite, as has been cited by Mr. Kelly here—despite widespread belief that this was a cause of many bank failures, Mr. White concluded quite the opposite. And I think it's a very persuasive argument.

The CHAIRMAN. Will you give us the citation so we can get the article? We would like to have it for the record.

Mr. PERKINS. All right.

[The following information was subsequently submitted for the record.]

[50] *Id.*

[51] *Id.* at 308–309.

[52] S. Kennedy, note 39 *supra*, at 19; C. Bremer, note 25 *supra*, at 11.

[53] *See* M. Friedman & A. Schwartz, note 23 *supra*, at 309–311; M. Nadler & J. Bogen, note 9 *supra*, at 42. *See also* S. Kennedy, note 9 *supra*, at 1–3.

[54] *See id.* at 1; M. Friedman & A. Schwartz, note 23 *supra*, at 309–311.

[55] *See id.* at 310–311.

[56] *See, e.g.*, Peach, note 9 *supra*, at 151.

[57] *S. Res. 71 Hearings*, note 9 *supra*, at 1054.

[58] *Id.* at 1058.

[59] *See, e.g.*, P. Temin, Did Monetary Forces Cause the Great Depression? 91–94 (1976); Perkins, note 9 *supra*, at 496–497; Werner, "Biggest Bank Failure," *Fortune* 62 (March 1933).

[60] *See, e.g.*, P. Temin, note 59 *supra*, at 91–94; Werner, note 59 *supra*. *See also* 75 Cong. Rec. 9805 (daily ed. May 10, 1932) (statement of Sen. Walcott).

[61] Perkins, note 9 *supra*, at 497.

[62] *Id.*

[63] *Id.*

[64] *S. Res. 71 Hearings*, note 9 *supra*.

[65] *See* note 34 *supra* and accompanying text.

[66] *S. Res. 71 Hearings*, note 9 *supra*, at 1.

[67] *See* 75 Cong. Rec. 9973 (daily ed. May 11, 1932) (statement of Sen. Norbeck); Treasury Paper, note 9 *supra*, at A-13.

[68] H. P. Willis & J. Chapman, note 43 *supra*, at 32. *See also S. Res. 71 Hearings*, note 9 *supra*, at 50 (statement of Sen. Glass); M. Friedman & A. Schwartz, note 23 *supra*, at 191; *The Chase Economic Bulletin*, vol. 12, no. 1, at 5 (Apr. 25, 1932). Professor Willis of Columbia was Glass' principal advisor on the Glass-Steagall Act and served as special counsel to the subcommittee. *See S. Res. 71 Hearings*, note 9 *supra*, at 1. Willis also had helped Glass to draft the Federal Reserve Act. *See* Perkins, note 9 *supra*, at 498. *See also* Treasury Paper, note 9 *supra*, at A-12–A-15; Peach, note 9 *supra*, at 151–152; Perkins, note 9 *supra*, at 497–505.

[69] *Brokers' Loans: Hearings Before the Senate Comm. on Banking and Currency on S. Res. 113*, 70th Cong., 1st Sess. 16 (1928) (statement of Dr. Henry Parker Willis) [hereinafter *Brokers' Loans Hearings*]. *See also* M. Friedman & A. Schwartz, note 23 *supra*, at 191–192.

[70] *Brokers' Loans Hearings*, note 69 *supra*, at 53 (statement of Sen. Glass). *See also The Chase Economic Bulletin*, vol. 12, no. 1, at 5 (April 25, 1932).

[71] *See generally* Treasury Paper, note 9 *supra*, at A-12–A-15; Perkins, note 9 *supra*, at 497–505.

[72] *See* 75 Cong. Rec. 9887 (daily ed. May 10, 1932) (statement of Sen. Glass). *See also* Perkins, note 9 *supra*, at 500.

[73] *S. Res. 71 Hearings*, note 9 *supra*, at 990. At one point early in the hearings Glass indicated the nature of his agenda when he stated:

> [W]hen we have had occasion to propose modifications of either the Federal Reserve Act or the National Banking Act it has seemed to me that instead of creating a national standard of sound banking which the State systems might be induced to follow, we have introduced into the national banking system some, if not many, of the abuses of the State systems, in order to enable national banks to compete with State banks. *Id.*, at 14.

It is noteworthy that Glass apparently had some doubts about the feasibility of separating securities affiliates from commercial banks. He stated: "Well I myself . . . rather question the feasibility maybe of abolishing [securities affiliates] because they have been permitted for so long to exist. It might create a confusion and embarrassment that would be worse than the evil itself." *Id.*, at 40. But Glass did say that if it were not possible to control securities affiliates, "[he] should be agreeable to prohibiting them." *Id.*, at 41.

[74] *Id.* at 1001.

[75] *Id.* at 1057. The subcommittee's discussion highlights the broad scope of the term *securities affiliate* as used by Congress during its consideration of the Glass-Steagall Act. The subcommittee stated that securities affiliates served as: (1) wholesalers of security issues; (2) retailers of securities; (3) holding and finance companies; (4) investment trusts (engaged in buying and selling securities acquired purely for investment or speculative purposes); (5) assets realization companies (used to take over from the parent bank loans and investments that proved to be doubtful or illiquid); (6) mediums for supporting the market for the bank's own stock; and (7) real estate holding companies. The subcommittee noted that "in most cases" the securities affiliates "exercised a combination of these functions, and in some instances they have exercised all of them." *Id.*

[76] *Id.* at 1063. The subcommittee described this debtor-creditor relationship as "very prevalent," *id.*, and characterized it as "the most direct manner in which the affiliate may impair the liquidity of the bank." *Id.* at 1064. In a succeeding subsection of the appendix, the subcommittee stated:

> The loan relationship as it exists between the bank and its affiliate differs from that prevailing with the general run of the bank's customers in an essential respect. When dealing with its affiliate, the bank is really dealing with itself, in view of the identity of ownership and management that is established. As a result, there tends to be a breaking down of those limitations on the extension of credit which the bank sets up in other cases to guard against the making of excessive or poorly-secured loans. *Id.* at 1066.

[77] *Id.* at 1063–1064.

[78] S. Kennedy, note 39 *supra*, at 19.

[79] *See* R. Patterson, note 21 *supra*, at 190–93; M. Nadler & J. Bogen, note 9 *supra*, at 70–71.

[80] S. Kennedy, note 39 *supra*, at 20.

[81] S. Rep. No. 584, 72d Cong., 1st Sess. 6 (1932).

[82] S. 3215, 72d Cong., 1st Sess., 75 Cong. Rec. 2403 (daily ed. Jan. 21, 1932).

[83] *See* notes 35–38 *supra* and accompanying text.

[84] S. 3215, note 82 *supra*, at Sections 20, 23, 24.

[85] *Id.*, at Sections 18, 21.

[86] *Id.*, at Section 33.

[87] *Id.*

[88] *See* note 68 *supra*.

[89] H. P. Willis & J. Chapman, note 43 *supra*, at 82.

[90] Pujo Report, note 19 *supra*, at 164.

[91] *S. Res. 71 Hearings*, note 9 *supra*, at 271, 277 (statement of John A. Broderick, Superintendent of Banks, State of New York).

[92] M. Nadler & J. Bogen, note 9 *supra*, at 53.

[93] *See* N.Y. Times, Jan. 27, 1932, at 1. *See also* N.Y. Times, Jan. 28, 1932, at 10; N.Y. Evening Post, Jan. 30, 1932, at 1.

[94] 75 Cong. Rec. 2999 (daily ed. Feb. 1, 1932) (statement of Sen. Glass).

[95] S. 4115, 72d Cong., 1st Sess., 75 Cong. Rec. 6329 (daily ed. March 17, 1932).

[96] *Id.* at Sections 17, 20.

[97] *See Operation of the National and Federal Reserve Banking Systems: Hearings on S. 4115 Before the Senate Comm. on Banking and Currency*, 72d Cong., 1st Sess. (1932) [hereinafter *S. 4115 Hearings*].

[98] *See, e.g.*, *id.* at 17–18 (statement of Allan M. Pope, President, Investment Bankers' Association of America); *id.*, at 59 (statement of Harry J. Haas, President, American Bankers' Association). At one point, Glass suggested that the bankers were testifying as part of an "organized protest." *Id.* at 447. *See also* N.Y. Times, March 31, 1932, at 1.

[99] *S. 4115 Hearings*, note 97 *supra*, at 501 (Letter of George L. Harrison, Governor, Federal Reserve Bank of New York). Governor Harrison's letter had been unanimously approved by the directors of the Bank. *Id.*, at 496.

[100] *Id.* at 501.

[101] *Id.*, at 357 (statement of Eugene Meyer, Governor, Federal Reserve Board).

[102] *Id.* at 388.

[103] *Id.* The provision suggested by Meyer contained language virtually identical in major respects to the language that ultimately was included in Section 20 of the Glass-Steagall Act.

It is noteworthy that Meyer offered the Board's proposal as a substitute for Section 18 of S. 4115. *Id.* Section 18 of S. 4115 was similar to the provision that ultimately became Section 32 of the Glass-Steagall Act. Meyer stated that he was offering the substitute because Section 18 "would be capable of easy evasion and would become ineffective in many cases." *Id.*, at 387. He also criticized Section 18's prohibition of correspondent relationships between member banks and certain types of business entities as overly broad. *Id.* at 387–388.

[104] *Id.*, at 388.

[105] *Id.*

[106] *Id.* In response to questions, Meyer later stated that "it is impossible to classify absolutely all affiliates that deal in securities as wicked and vicious." *Id.*, at 393.

[107] S. 4412, 72d Cong., 1st Sess., 75 Cong. Rec. 8350 (daily ed. April 18, 1932).

[108] *Id.* *See also* S. Rep. No. 584, 72d Cong., 1st Sess.

[109] S. 4412, note 107 *supra*, at Section 18. S. 4412, however, also reflected Meyer's suggestion that his proposal be substituted for Section 18 of S. 4115. As noted, *see* note 103 *supra*, Section 18 of S. 4115 was a predecessor of Section 32 of the Glass-Steagall Act. After this section was eliminated from S. 4412, a provision similar to Section 32 did not reappear until May 1933 when Glass introduced S. 1631. *See* S. 1631, 73d Cong., 1st Sess. sec. 31, 77 Cong. Rec. 3109 (daily ed. May 10, 1933).

[110] S. Rep. No. 584, 72d Cong., 1st Sess. 8 (1932).

[111] *Id.*, at 9–10.

[112] 75 Cong. Rec. 9888, 9898 (daily ed. May 10, 1932) (statement of Sen. Glass).

[113] *Id.* at 9887 (daily ed. May 10, 1932) (statement of Sen. Glass).

[114] *Id.*

[115] *Id.*, at 9883 (daily ed. May 10, 1932) (statement of Sen. Glass).

[116] *Id.*, at 9906 (daily ed. May 10, 1932) (statement of Sen. Walcott).

[117] *Id.* *See also id.*, at 9911 (daily ed. May 10, 1932) (statement of Sen. Bulkley).

[118] *Id.*, at 9909, 9912, 9914 (daily ed. May 10, 1932) (statement of Sen. Bulkley).

[119] *Id.* at 9913 (daily ed. May 10, 1932) (statement of Sen. Bulkley).

[120] *Id.* at 9911–9913 (daily ed. May 10, 1932) (statement of Sen. Bulkley).

[121] *See S. Res. 71 Hearings*, note 9 *supra*, at 1063–1064; notes 76–77 *supra* and accompanying text.

[122] *See* 75 Cong. Rec. 9912 (daily ed. May 10, 1932) (statement of Sen. Bulkley).

[123] *See* Perkins, note 9 *supra*, at 518. Perkins suggests that the Republican leadership wanted to avoid "agitation" on banking issues just before a national campaign. *Id.*

[124] *See* 76 Cong. Rec. 1940 (daily ed. Jan. 17, 1933) (statement of Sen. Glass); V. Carosso, note 29 *supra*, at 370.

[125] *See* 76 Cong. Rec. 1940 (daily ed. Jan. 17, 1933) (statement of Sen. Glass). *See also id.*, at 1407 (daily ed. Jan. 9, 1933) (statement of Sen. Glass).

[126] *See, e.g.*, *id.*, at 1452 (daily ed. Jan. 10, 1933) (statement of Sen. Long); *id.*, at 2208 (daily ed. Jan. 21, 1933) (statement of Sen. Glass). *See also* S. Kennedy, note 39 *supra*, at 73, 207–208; M. Nadler & J. Bogen, note 9 *supra*, at 54.

[127] 76 Cong. Rec. 2517 (daily ed. Jan. 25, 1933).

[128] *Id.* at 2000 (daily ed. Jan. 18, 1933) (statement of Sen. Glass).

[129] *Id.* *See also* N.Y. Timer, Dec. 22, 1932, at 27; N.Y. Times, Jan. 11, 1933, at 27.

[130] 76 Cong. Rec. 2407–2408 (daily ed. Jan. 24, 1933). *See also id.*, at 2408 (daily ed. Jan. 24, 1933) (statement of Sen. Glass).

See S. Kennedy, note 39 *supra*, at 73–74; H. P. Willis and J. Chapman, note 43 *supra*, at 98; Perkins, note 9 *supra*, at 521. One commentator has suggested that the House was initially reluctant to act on the bill because President-elect Roosevelt still had problems with it. In particular:

> Roosevelt believed the Glass proposals did not go far enough: he wanted protection on investors against fictitious or bad securities, segregation of savings from commercial deposits, revision of the liquidating corporation clause to permit immediate reopening of failed banks, and branch banking limited to no more tian a countrywide basis. S. Kennedy, note 39 *supra*, at 73.

When the House finally considered the bill, "debate bogged down over the guarantee of bank deposits." *Id.* at 74.

[132] *See generally Stock Exchange Practices: Hearings Before a Subcomm. of the Senate Comm. on Banking and Currency on S. Res. 84 and S. Res. 239*, 72d Cong., 2d Sess. (1933).

[133] *See* F. Pecora, Wall Street under Oath 70–123 (1939). *See also* V. Carosso, note 29 *supra*, at 330. *See generally* S. Kennedy, note 39 *supra*, at 111–119. There appears to be a consensus among the commentators that the Pecora hearings were a significant factor in the passage of the Glass-Steagall Act. *See, e.g.*, Treasury Paper, note 9 *supra*, at A-23; S. Kennedy, note 39 *supra*, at 212; V. Carosso, note 29 *supra*, at 330; H. P. Willis & J. Chapman, note 43 *supra*, at 101–102; M. Nadler & J. Bogen, note 9 *supra*, at 44; Karmel, *Glass-Steagall: Some Critical Reflections*, 97 Banking L. J. 631, 637 (1980); Perkins, note 9 *supra*, at 522.

[134] *See* Treasury Paper, note 9 *supra*, at A-22; S. Kennedy, note 39 *supra*, at 158–159, 204; R. Patterson, note 21 *supra*, at 197; M. Nadler & J. Bogen, note 9 *supra*, at 146.

[135] *See* S. Rep. No. 77, 73d Cong., 1st Sess. 6 (1933).

[136] M. Nadler & J. Bogen, note 9 *supra*, at 35.

[137] S. Kennedy, note 39 *supra*, at 18–19.

[138] *See id.* at 63–64; M. Friedman & A. Schwartz, note 23 *supra*, at 325.

[139] Two commentators have suggested that "the growth of postal savings deposits from 1929 to 1933 is one measure of the spread of distrust of banks." *Id.* at 308 n. 8. In November 1914, postal savings deposits totaled $57 million. By August 1929 they had grown by only $100 million. In October 1930, they stood at $190 million. Between then and March 1933 they increased to $1.1 billion. *Id. See also* J. F. T. O'Connor, Banks under Roosevelt 24 (1938).

[140] *See* M. Friedman & A. Schwartz, note 23 *supra*, at 326.

[141] *Id.* at 355.

[142] S. Rep. No. 77, 73d Cong., 1st Sess. 6 (1933).

[143] *See* M. Friedman & A. Schwartz, note 23 *supra*, at 325.

[144] *See* S. Kennedy, note 39 *supra*, at 144, 149–150; M. Friedman & A. Schwartz, note 23 *supra*, at 326; M. Nadler & J. Bogen, note 9 *supra*, at 141, 153. Between February 1 and March 1, the interior banks withdrew $760 million in balances they held with New York banks. M. Friedman & A. Schwartz, note 23 *supra*, at 326.

[145] *See id.* at 325; S. Kennedy, note 39 *supra*, at 144–145, 155 n. 9.

[146] *See id.* at 203. *See generally* C. Colt & N. Keith, 28 DAYS (1933); C. Bremer, note 25 *supra*, at 18–19. The emergency banking legislation, among other things, granted the President certain emergency banking and currency powers, provided for the appointment of conservators for certain national banks with impaired assets, permitted the Reconstruction Finance Corporation to buy preferred stock, capital notes, and debentures of banks, and provided for emergency issues of Federal Reserve Bank notes. *See* M. Friedman & A. Schwartz, note 23 *supra*, at 421–422, 427 n. 4.

[147] *See* Wall St. Journal, Mar. 10, 1933, at 8; N. Y. Times, March 9, 1933, at 1. *See also Stock Exchange Practices: Hearings Before the Senate Comm. On Banking and Currency on S. Res. 84 and S. Res. 56*, 73d Cong., 2d Sess. 3977 (statement of Winthrop W. Aldrich, President, Chase National Bank) [hereinafter *Stock Exchange Practices Hearings*].

[148] *See* Wall St. Journal, Mar. 10, 1933, at 8; N. Y. Times, March 9, 1933, at 1. The National City Bank had announced its plan to drop its affiliate the day before Aldrich's announcement. *See* Wall St. Journal, March 9, 1933, at 4; N. Y. Times, March 9, 1933, at 1.

[149] *See* Wall St. Journal, Mar. 10, 1933, at 8.

[150] *Id. See also Stock Exchange Practices Hearings*, note 147 *supra*, at 3979 (statement of Winthrop W. Aldrich, President, Chase National Bank).

[151] S. Kennedy, note 39 *supra*, at 212–213. *See also* M. Nadler & J. Bogen, note 9 *supra*, at 54.

[152] S. Kennedy, note 39 *supra*, at 212–213. *See also* Wall St. Journal, Mar. 13, 1933, at 5 (President of bank in Cincinnati supports Aldrich); Wall St. Journal, Mar. 16, 1933, at 6 (President of bank in Cleveland supports Aldrich).

Aldrich's announcement did not meet with universal approval. Arthur Schlesinger offers the following description:

> In March [1933], Winthrop Aldrich, succeeding the unfortunate [Albert H.] Wiggin as head of the Chase, made an unexpected demand for the separation of commercial and investment banking. This represented, however, very much a minority view on Wall Street. Aldrich's action was interpreted as a Rockefeller assault on the House of Morgan, and for a time he achieved almost the dignity of a traitor to his class. W. C. Potter of the Guaranty Trust characterized his proposals as "quite the most disastrous" he had "ever heard from a member of the financial community," and J. P. Morgan himself predicted that separation of deposit and investment banking would have the most dire effects on his firm's future ability to supply capital "for the development of the country."
> [A. Schlesinger, The Age of Roosevelt: The Coming of The New Deal 434–435 (1958).]

As Schlesinger notes, Aldrich's announcement probably was directed at the House of Morgan. See S. Kennedy, note 39 *supra*, at 212–213; N. Y. Times, March 9, 1933, at 1; Wall St. Journal, March 10, 1933, at 8.

[153] Peach, note 9 *supra*, at 158.

[154] Perkins, note 9 *supra*, at 522.

[155] S. 245, 73d Cong., 1st Sess., 77 Cong. Rec. 196 (daily ed. Mar. 11, 1933).

[156] S. 1631, 73d Cong., 1st Sess., 77 Cong. Rec. 3109 (daily ed. May 10, 1933).

[157] *Id.* at Section 21. It appears that Winthrop Aldrich was largely responsible for the inclusion of Section 21 in S. 1631. The section was consistent with some of the proposals Aldrich had made in March. *See* notes 148–150 and accompanying text. Moreover, in a biography of Aldrich, A. M. Johnson credits Aldrich with drafting the section of the Glass bill "prohibiting firms dealing in securities from accepting deposits," and states that Glass later acknowledged Aldrich's contribution. *See* A. Johnson, Winthrop W. Aldrich 156 (1968). This is true. When Aldrich testified at the Stock Exchange Practices Hearings in late 1933, Glass confirmed that he had met with him to discuss the Glass-Steagall Act. During the course of a discussion with Glass at these hearings, Aldrich took credit for drafting Section 21. *See Stock Exchange Practices Hearings*, note 147 *supra*, at 4016, 4032 (statement of Sen. Glass) (colloquy between Sen. Glass and Winthrop W. Aldrich). *See also* Wall St. Journal, May 11, 1933, at 1.

In view of certain elements of Aldrich's announcement in March 1933, *see* notes 148–150 and accompanying text, note 152 *supra*; S. Kennedy, note 39 *supra*, at 212–213, it is likely that Section 21 was drafted with J. P. Morgan in mind. *See also* J. Brooks, note 21 *supra*, at 149, 211; 8 St. John's L. Rev. 193, 195–196 (1933).

As noted, *see* notes 90–91 accompanying text, provisions similar to section 21 had been in existence for years.

[158] S. 1631, note 156 *supra*, at Section 31.

[159] *Id.* at Sections 16, 20, 21, and 31.

[160] *See* S. Rep. No. 77, 73d Cong., 1st Sess. (1933).

[161] *Compare id.* at 8–10 *with* S. Rep. No. 584, 72d Cong., 1st Sess. 8–10 (1932).

[162] 77 Cong. Rec. 3726 (daily ed. May 19, 1933) (statement of Sen. Glass).

[163] *Id.* at 3730 (daily ed. May 19, 1933) (statement of Sen. Glass).

[164] *Id.*

[165] *Id.*

[166] *Id.* at 4178–80 (daily ed. May 25, 1933); *id.* at 4179 (daily ed. May 25, 1933) (statement of Sen. Bulkley). The thrust of the amendment to Section 21 offered by Senator Tydings was not clear and his description of it was very confused. *See id.* at 4178–79 (daily ed. May 25, 1933) (statement of Sen. Tydings). He appears to have had some concern about the constitutionality of Section 21. *Id.* Senator Glass assured him that the provision was constitutional. In this regard, Glass ackowledged that he was not a lawyer, but stated that he had "been supplied with a document . . . at least an inch thick, which gave our committee opinion after opinion, of inferior, superior, supreme Federal courts, in justification of the authority which we here try to assert." *Id.* at 4179 (daily ed. May 25, 1933) (statement of Sen. Glass).

[167] *Id.* at 4179 (daily ed. May 25, 1933) (statement of Sen. Bulkley); *id.* at 4180 (daily ed. May 25, 1933) (statement of Sen. Glass).

[168] *Id.* at 4180 (daily ed. May 25, 1933) (statement of Sen. Bulkley). For the later significance of this amendment, see note 8 *supra*.

[169] 77 Cong. Rec. 4180 (daily ed. May 25, 1933) (statement of Sen. Bulkley).

[170] *Id.* (daily ed. May 25, 1933).

[171] *Id.* at 4182 (daily ed. May 25, 1933). As a technical matter, the Senate agreed to Glass' motion to substitute the provisions of S. 1631 for the House-passed version of the bill, *see id.* at 4181–82 (daily ed. May 25, 1933), and then passed H. R. 5661. *Id.* at 4182 (daily ed. May 25, 1933).

The House had passed H. R. 5661 by a vote of 262 to 19 on May 23, 1933. *See id.* at 4058 (daily ed. May 23, 1933). This chapter focuses on activities in the Senate because the House, at least with respect to the provisions of interest here, basically followed the Senate's lead. *See, e.g.*, *id.* at 3835 (daily ed. May 22, 1933) (statement of Rep. Steagall). The principal force behind the legislation was Senator Glass. Moreover, the debates on the legislation in the House were very similar to those in the Senate. *See, e.g.*, *id.* ("The purpose of the regulatory provisions of this bill is to call back to the service of agriculture and commerce and industry the bank credit and the bank service designed by the framers of the Federal Reserve Act.") ("The purpose [of the bill] is to strengthen the banking structure, . . . to provide more effective regulation and supervision to eliminate dangerous and unsound practices, and to confine banks of deposit to legitimate functions and to separate them from affiliates or other organizations which have brought discredit and loss of public confidence.").

[172] *See id.* at 5861 (daily ed. June 13, 1933) (statement of Sen. Glass); *id.* at 5892 (daily ed. June 13, 1933) (statement of Rep. Steagall).

[173] *See id.* at 5863 (daily ed. June 13, 1933) (Senate); *id.* at 5898 (daily ed. June 13, 1933) (House).

[174] It is noteworthy that the drafters of the Glass-Steagall Act may have thought that it would have a broader scope than it has today. Other provisions of the Banking Act of 1933 would have required all banks "availing themselves of the permanent insurance provision of the bill" to become "members of the Federal Reserve Banking system." *Id.* at 5861 (daily ed. June 13, 1933) (statement of Sen. Glass). *See also id.* at 5896 (daily ed. June 13, 1933) (statement of Rep. Luce); *Stock Exchange Practices Hearings*, note 147 *supra*, at 4034 (statement of Sen. Glass); 8 St. John's L. Rev. 193, 195 (1933).

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HOW WELL DID COMMERCIAL AND INVESTMENT BANKING MIX BEFORE GLASS-STEAGALL ?

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In the current debate over whether or not to remove the Glass-Steagall Act's barrier which separates commercial and investment banking, it is important to examine how banks operated before its passage. The opponents of any revision in the law frequently remind Congress and the public of the banks' alleged misdeeds which originally prompted this legislation. There is considerable concern that allowing banks free entry into the securities business will cause the problems of the 1920s and 1930s to reappear. However, commercial banks' behavior before 1933 shows that their securities activities endangered neither the banks nor the economy as a whole.

In looking back at this crucial period, it is a common mistake to confuse the problems of the securities industry in general with the specific problems that may have been spawned by commercial banks' involvement. After the stock market collapsed in 1929, the practices of promoters and sellers of securities--brokerage houses, investment banks and commercial banks--came under scrutiny. The New Deal laws regulating the securities business were put in place to protect investors from certain

practices of all of its members. If banks should re-enter this business they would, of course, be governed by the same regulations. The public would have the same assurance in dealing with them as with the existing firms. The real issue is whether commercial banks would create some additional problems that cannot be handled by current regulation.

One objection to weakening Glass-Steagall is that the economy will become more unstable. This argument is put forward because banks sometimes have been held responsible for bringing about the crash of the stock market--an event often regarded as beginning the Great Depression. This view is unacceptable to modern scholarship on two accounts. First, banks cannot be blamed for the stock market bubble because they handled only a fraction of the trading. Secondly, although the crash may have contributed to the onset of the depression, economists and historians regard it as a minor factor. The most important roles are given to the decline in consumption and investment, the tariff war, and the failure of the Federal Reserve to counter the effects of banking panics. While different weights have been placed on these events by different historians, none currently subscribe to the view that banks' involvement in the securities business caused the collapse of the economy.

Sometimes the high rate of bank failure in the thirties is blamed on the merging of commercial and investment banking. This contention does not stand up to close examination. During the years 1930-1933, 26.3% of all national banks (few non-national banks were engaged in the securities business) failed while only 6.5% of those that had securities affiliates closed their doors. In a recently published study, I found that a securities business did not increase the likelihood of a bank's failure but instead tended to reduce it. This surprising result is easy to explain. The banks that became heavily involved in securities activities were usually the larger city banks that were well-run and well-diversified. The vast majority of bank failures occurred in rural areas. These were small banks whose business was dependent on local agriculture. When prices for agricultural products collapsed, these banks failed by the hundreds.

It is true that investment banking was riskier than commercial banking; the variance (and also the mean) of the rate of return on banks' security affiliates was higher than on their commercial banking activities. However, swings in income from the banks' securities business did not coincide with swings in revenue from their ordinary business. Instead of creating problems for a bank, combining the two activities helped to smooth out fluctuations in earnings.

Looking at banks' liquidity and capital adequacy provides another check on the effects of deregulation. In my study of the period before 1933, I discovered that a greater involvement in investment banking had no significant adverse effect on

commercial bank capitalization or liquidity. In fact, sometimes it had a positive effect. This simply reflects the fact that a higher degree of risk led bank managers to take steps to protect their institutions and customers.

The historical record of commercial banks' behavior when they were allowed into the securities business strongly suggests that they should no longer be barred from it. Any qualms about the danger to themselves and the economy as a whole is unjustified. While the costs of excluding banks from securities markets has been wildly exaggerated, the benefits have been largely ignored. In the 1920s, banks expanded the market for securities beyond the small well-to-do clientele of investment banks. The lower fees they charged made them the equivalent of today's discount brokers. Commercial banks' ability to distribute stocks enabled them to obtain desirable positions in underwriting syndicates. A securities business was complementary to the financial services already provided by banks. The banks were thus capable of offering the public a wide array of financial services, often at lower cost.

If there is no case to be made for Glass-Steagall, the last question that must be answered is why Congress passed this legislation in the first place. While some supporters of this act have criticized banks for challenging the wisdom of Congress, it was not Congress but one Senator, Carter Glass, who engineered the division of commercial and investment banking.

When the New Deal banking legislation was being prepared, virtually all Congressmen on the key committees believed that any problems could be corrected by bringing banks' securities affiliates under the regulation of the Federal Reserve. But not Senator Glass. Head of the Senate Banking Committee and one of the architects of the Federal Reserve System, Glass held very strong views about how the banking system ought to operate. He was convinced that commercial banking was totally unsafe unless it was restricted to short-term loans and kept immaculately clean of investment banking. Glass' ideas were based on a nineteenth century banking theory, the Real Bills Doctrine. This theory has long since been discredited and is not taken seriously by either academic economists or officials of the Federal Reserve. Glass was alone in his devotion to the separation of commercial and investment banking, but he was in a position to impose it as part of the overall legislative package.

The Glass-Steagall Act of 1933 has forced an artificial division of financial markets upon institutions. The historical record shows that there is no case for excluding commercial banks from the securities business. The principle effect of the act has been to reduce the efficiency and raise the costs of America's financial industry.

EXPLORATIONS IN ECONOMIC HISTORY 23, 33–55 (1986)

Before the Glass–Steagall Act: An Analysis of the Investment Banking Activities of National Banks*

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One of the fundamental features of the American banking system since the passage of the Glass–Steagall Act has been the strict separation of commercial and investment banking. This Act brought to an end the remarkable penetration of the securities business by commercial banks in the years before 1933. The intention of this legislation was to eliminate the practices of banks and their securities affiliates that were held partly responsible for the crash of the stock market and the collapse of the banking system.

As the barriers erected by the Glass–Steagall Act begin to weaken and banks gradually reenter the securities field, concern has again arisen that this activity is not appropriate for commercial banks. The problems of the 1930s are cited as evidence that banks should be kept out of investment banking. Although the securities operations of banks were the subject of extensive Congressional hearings, they have never been carefully analyzed. This paper focuses on the national banks and their affiliates and reexamines the growth and conduct of commercial banks' securities business before 1933. Little evidence is found for the alleged deleterious effects that security affiliates' operations were supposed to have had on the soundness of banks. The development of security affiliates represented an attempt by commercial banks to expand their activities beyond the limited ones permitted to them by regulation. This diversification allowed the banks to gain new business as their more traditional activities stagnated and to take advantage of significant complementarities in the production of financial services.

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THE ORIGINS OF NATIONAL BANKS' SECURITIES BUSINESS

In its first effort to define commercial banking, Congress sought to restrict national banks to a narrow range of financial activities. According to the National Banking Act of 1864, a national bank's prescribed role was to invest its funds in short-term, self-liquidating loans to finance goods in the process of production or exchange. But, whatever Congress' original intention was, national banks could not conduct such a limited business and survive in the tough competition of the American financial markets. The national banks did have one important loophole in the law: they were permitted to perform such "incidental" activities as were necessary to their operations (Peach, 1941, pp. 7–19). In practice, this was generally interpreted by the courts to mean that they could take up almost any financial activity that was not specifically prohibited to them by law.

This proved to be very important to national banks when they were confronted with competition from state-chartered banks, however, this loophole had its limitations. At the turn of the century, trust companies presented a grave challenge to national banks because of their ability to combine commercial banking with fiduciary powers not granted to national banks. When the growth of trust companies threatened to usurp their place, commercial banks discovered the legal device of the affiliate. This allowed them to set up affiliated trust companies and indirectly supply trust services to their customers. The use of affiliates allowed a bank to get into almost any type of financial intermediation. At a Congressional hearing in 1932, Federal Reserve Board Governor Eugene Meyer presented a list (U.S. Senate, 1932, p. 392) of all known national bank affiliates. Security, realty, bank building and safe deposit affiliates led a list totaling 770.

Before the First World War few national banks were involved in the securities business. Their activities in this area were largely confined to trading for and giving advice to their customers upon request. This business was limited to bonds as national banks were forbidden to handle common stocks because they were not evidences of debt. Their capacity to operate in this area was further circumscribed because it was declared to be *ultra vires* or beyond their corporate powers and unhappy customers could not obtain satisfaction in the courts (Peach, 1941, pp. 44–50).

The enormous borrowing needs of the federal government during World War I required the assistance of all financial intermediaries. Many commercial banks handled their first security issues in the campaigns to distribute Liberty bonds, and many of their customers bought their first bonds from them. The campaigns were a tremendous success, and some historians (Carosso, 1970) have claimed that the wartime bond drives interested the public in securities for the first time. While banks were drawn into the securities business by their wartime experience, they

were also pushed into it by the declining demand for commercial loans which forced them to seek new sources of income. Many successful firms shifted their method of financing from commercial loans to stock and bond issues (Currie, 1931). To meet the changing requirements of their main customers, commercial banks altered their methods of intermediation.

One of the key characteristics of the postwar movement of commercial banks into investment banking was the emergence of the security affiliate. While many banks expanded their securities operations through their bond departments, the more aggressive banks established security affiliates. These affiliates were based on the model of the trust company affiliate; however, they were incorporated under the general laws of incorporation rather than under state banking and trust laws. This meant that they could engage in virtually any type of financial transaction not governed by banking or trust laws.

There were three basic methods of organizing a security affiliate. The first and most common was where the banks' stockholders were given a *pro rata* interest in the stock of the affiliated company. In the second, the affiliate was carried as an investment of the bank; in the third, the investment company was owned by a holding company that also owned the bank (Preston and Finlay, 1930a). Typically, the affiliate had a name that was very similar to that of the parent bank; and it usually had offices in the same building. Although it was not a department within the bank, the affiliate could easily offer investment banking services to the bank's customers. Conducting a securities business through an affiliate rather than the bond department meant that common stocks and other business strictly forbidden to commercial banks could be handled. Furthermore, the bond departments' securities operations were under the *ultra vires* handicap. This was not removed until 1927 by McFadden Act that gave legal authority to national banks to sell bonds.

In the boom decade of the 1920s, national banks' securities business grew rapidly. In 1922, national banks had only 10 security affiliates and another 62 banks were prominently engaged in securities operations through their bond departments. In the peak year of 1931, there were 114 national bank affiliates and 123 conducting business in their bond departments (Peach, 1941, p. 83). Many more national banks traded securities and gave investment advice on an occasional basis (White, 1984b).

Banks tailored their operations to the needs of their customers. The Wachovia Bank and Trust Company of Asheville, North Carolina, helped its depositors who wanted to diversify their investments beyond savings deposits. It gave conservative advice and recommended that customers first purchase Liberty issues followed by North Carolina, municipal, railroad, public utility, industrial, and finally real estate mortgage bonds (Patterson, 1925). The money center banks had more varied activities than the country banks. One of the most prominent security affiliates was the First National Old Colony Corporation of Boston. It served not only the First National Old Colony Bank's customers but also other banks. The affiliate had an investment supervision department which assisted with customers' portfolio selection. It had as its clients approximately 600 banks, many large corporations, and even some insurance companies and managed over 1 billion dollars of securities. State regulatory authorities paid respect to the knowledge of this affiliate. The firms' president testified in Congress (U.S. Senate, 1932) that "we have had presidents of banks come to this corporation and say that bank examiners have told them if they did not take our advice in security matters it would probably be necessary to close their banks." Even the inquisitorial Senator Carter Glass was impressed and commented, "I conceive that Mr. Pope has perhaps described an ideal and virtuous affiliate."

THE ATTRACTIONS OF INVESTMENT BANKING

Although the outbreak of the First World War accelerated the entry of commercial banks into the securities business, they probably would have entered the field even without the war. Once they had begun a securities business, commercial banks found that strong complementarities between various aspects of commercial and investment banking gave them important competitive advantages.

Commercial banks had established extensive retailing networks among their depositors during the war. Unlike investment bankers who generally had a small clientele of the well-to-do, commercial banks had large numbers of potential customers, each of whom could invest a small amount in securities. Many customers were attracted by the smaller commissions they charged. Banks seem to have been the contemporary equivalents of "discount brokers" with fees of about one-quarter the New York brokerage commission (Preston and Finlay, 1930a).

Banks were able to broaden the market and this ability to distribute securities drew them into other areas of investment banking. In the floatation of new issues, banks with distribution networks were in a preferred position to obtain desirable participations in underwriting syndicates. The issuing investment houses wanted to have securities purchased not by speculators but by investors who would deposit them in safe deposit boxes and await their dividends (Peach, 1941, p. 75). The practice of acting as participating distributor became quite common. By the end of the decade, many banks in money centers underwrote, distributed, and dealt in most types of bonds. Outside of large cities, banks specialized in originating and underwriting local issues of municipal and real estate mortgage bonds.

Affiliates enjoyed another advantage in competing with private bankers and brokerage houses. Any of their parent banks' offices could be used to sell securities. In California, where banks were permitted extensive branching networks, affiliates maintained no separate offices and extended services to banks' clients through the parents' branches. In other states, security affiliates tied to bank holding companies or chains handled the bond business of banks in the group (Peach 1941, p. 101).

There were also benefits for the parent banks. They could take advantage of the larger, more specialized research staffs of the affiliates to analyze purchases on their own account and loans made on collateral of securities (Osterweis, 1932). The affiliates also allowed banks to circumvent geographical restrictions on their activities. Unlike national banks, an investment company could establish branches without limit; and some affiliates had offices across the country. In 1930, National City Company had 60 branches; Chase Securities Corporation, 26; First National Old Colony Corporation, 17; and Continental Illinois Company, 12 (Preston and Finlay, 1930b).

These advantages of tying commercial and investment banking together allowed banks to successfully penetrate the securities business. From 1927 to 1930, the percentage of bond issues originated by all banks and their affiliates rose from 22.0 to 44.6% with private investment banking houses' share declining accordingly. There was also a rising level of participation in all bond issues. Banks' and bank affiliates' total share increased from 36.8 to 61.8% (U.S. Senate, 1931). Commercial banks had become a major force in all aspects of investment banking on the eve of the Glass–Steagall Act.[1]

THE ATTACK ON SECURITY AFFILIATES

The stock market crash in 1929 and the long decline in securities prices stunned bond and stock holders. The coincident penetration of securities markets by affiliates and the boom in the stock market led many to conclude that the affiliates were chiefly responsible for the collapse of stock prices and the problems of the banking system.

Senate Resolution 71, passed in late 1929, gave authorization to hold hearings to examine broadly the securities business of banks and to recommend legislation to correct any defects in the banking system. The hearings focused on what were perceived to be a wide range of questionable financial practices by banks and their affiliates. These included the issuance of unsound and speculative securities, disseminating untruthful and misleading information on new issues, pool operations, deals for the personal profit of corporate officers, and abuses arising specifically from mixing commercial and investment banking functions (Peach, 1941, pp. 113–114). The majority of observers concluded that most of these problems were common to all security firms, not just affiliates, and could be remedied by appropriate regulation. However, a few critics insisted that only the legal separation of commercial and investment banking could eliminate certain abuses. These problems can be divided into those that occurred because of the conflict of interest for a bank serving its customers in more than one role and those that occurred because of the infiltration of commercial bank operations by the higher risk activities of investment banking.

In the 1920s, some financial writers worried about the competing needs within a bank to promote the securities of its business customers and to give prudent investment advice to its depositor–investors. Comments of this nature were a minor dissonant note while the stock market was healthy. After the crash, critics played up this conflict of interest. The Senate Committee on Banking and Currency heard testimony from Mr. Edgar Brown, tubercular and almost deaf, who had lost his savings of $100,000 after being cajoled by the National City Company to invest it in the bond and stock markets. The committee's counsel, Ferdinand Pecora, took this to be a typical example:

> Mr. Brown was no isolated specimen. There were thousands of his kind. They did not deal at arm's length, because they were dealing with a bank. A bank was supposed to occupy a fiduciary relationship and to protect its clients, not lead them into dubious ventures, to offer sound, conservative financial advice, not a salesman's puffing patter. . . . The introduction and growth of the investment affiliate had corrupted the very heart of these old fashioned banking ethics. (Pecora, 1939, pp. 88–89)

For Pecora and other critics, only the complete separation of commercial and investment banking could eliminate the perceived conflict of interest between serving a depositor and selling securities.

The Senate Banking and Currency Committee's other major concern was that commercial banks' soundness was threatened by their affiliates. Banks wanted to provide their customers with a full array of financial services under one roof and emphasized the ties to their affiliates. Thus, if one firm in the group were threatened, the others might feel obliged to give it assistance in some way. The Committee pointed to the frequent borrowing by affiliates from their banks and argued that affiliates made riskier decisions in the knowledge that they could obtain assistance if losses were incurred (Bogen, 1934, pp. 436–437). Banks were accused of giving affiliates aid by buying up the excess of unsuccessful securities issues and by making loans to the public to encourage the purchase of securities sold by their affiliates.[2] Even if a parent bank did not give open support, its reputation might be tarnished when the price of securities recommended by its affiliate fell (Perkins, 1971, p. 508). These practices and problems, the Committee believed, were undermining the safety of the banking system. A jaded public might easily lose confidence in such banks, withdrawing deposits and beginning a panic.

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[1] One of the major costs of the Glass–Steagall Act is that it has curtailed the entry into investment banking of the best positioned firms—the commercial banks. This may have reduced competition in the industry (Hayes *et al.*, 1983, pp. 22–24).

[2] Both the National City Bank and the Chase National Bank were singled out in Congressional hearings for supposedly engaging in these activities (Peach, 1941, pp. 135–9; Carosso, 1970, pp. 330–333).

While many congressmen would probably have been satisfied to impose some form of federal regulation on security affiliates, this was totally unsatisfactory to the adherents of the Real Bills Doctrine who held key positions in the Congressional hearings. The chairman of the subcommittee hearings was Senator Carter Glass, the most vehement opponent of bank affiliates in Congress. His principal advisor and Professor of Money and Banking at Columbia University was H. Parker Willis. Glass and Willis had cooperated closely in the design of the Federal Reserve Act and held clear views of how the banking system ought to be structured and operate. Willis saw a sharp division between the "two banking systems in the United States—one designed to furnish fixed capital, the other short-term funds" (Willis, 1934, p. 108). The former was inherently more risky than the latter. Combining the two inevitably led to an undermining of commercial banking. Willis praised the Glass–Steagall Act for drawing a dividing line between investment and deposit banking as part of the genius of the American banking system and in line with the intent of the Federal Reserve Act.

The 1932 draft of the Act met with strong opposition from the banks, the Federal Reserve Board, the Treasury Department and the White House. Nevertheless, Glass persevered. Working on the Democratic party platform, he ensured that it called for the divorce of commercial and investment banking, and he campaigned against the Hoover administration's failure to implement reform. After the election, Roosevelt gave the persistent Glass his assent (Perkins, 1971, pp. 518–519). The Banking Act of 1933 made the divorce final. After June 16, 1934, no member bank could be affiliated with any corporation, association, or business trust engaged principally in the issue, floatation, underwriting, public sale, or distribution at wholesale or retail through syndicate participation of stocks, bonds, debentures, notes, or other securities. Furthermore, no bank officer or director could be associated with any business engaged in these activities.

The case for the separation of commercial and investment banking depends on whether there were conflicts of interest for institutions engaging in both activities that seriously injured the public and whether the soundness of the banking system was threatened by the presence of securities affiliates or operations. The remainder of this paper focuses on the second question. As for the first question, there is some evidence to suggest that banks did not lure depositors into security markets to unload unsound issues on them, but further research is needed on this subject.[3]

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[3] Huertas and Silverman (1983) discuss the case of the Peruvian bonds, which Congressional investigators had singled out, and conclude that they were not inherently unsound.

DID SECURITY AFFILIATES ENDANGER BANKS?

The accusation that combining a securities business with commercial banking threatened the banking system was supported by a variety of arguments. In this section, the traditional evidence for the Glass–Steagall Act is examined, focusing on the effects of securities operations on bank failures, the possible incentives for draining resources from a commercial bank to its affiliate, the dangers from cyclical fluctuations in the securities business, and the effects of affiliates' activities on the solvency and liquidity of parent banks. Looking at this evidence, it is difficult to find convincing reasons for supporting the regulation adopted by Congress.[4]

1. Did a Securities Business Increase the Probability of Bank Failure?

One of the most convincing pieces of evidence that the union of commercial and investment banking posed no threat to parent banks is the significantly higher survival rate of banks with securities operations during the massive bank failures of 1930–1933. While 26.3% of all national banks failed in this period, only 6.5% of the 62 banks which had affiliates in 1929 and 7.6% of the 145 banks which conducted large operations through their bond departments closed their doors.[5] This superior record may be partially explained by the fact that the typical commercial bank involved in investment banking was far larger than average while most of the failures were among the smaller institutions. Larger banks had opportunities for diversification and attaining economies of scale, which if exploited could strengthen their position in the industry.

Given the relatively small number of banks with affiliates that failed, it is difficult to determine the separate effect of securities operations on the probability of bank failure. One approach is to use the technique I employed (White, 1984a) to examine the factors contributing to bank failures in the 1930s. This uses a logistic regression where the probability of bank failure is a function of various financial ratios. More capital to assets, cash to deposits, securities to assets, and deposits to assets are expected to decrease the probability of a bank closing, while higher loans to assets and bills payable and other liabilities to assets are expected to increase it. Unfortunately, the effects of bank size cannot be analyzed because the sample of failing banks was paired with a sample of banks of similar size from the same locales. Dummy variables were introduced to capture the effects of a security affiliate or an important dealer bond department.

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[4] Other criteria, such as avoiding a concentration of economic power, may be used as a basis for regulating financial intermediaries; but in this case, the focus of Congressional concern was on the financial system's safe and efficient operation.

[5] These were calculated with data from *Security Dealers of North America* (1929), the Board of Governors of the Federal Reserve System (1943), pp. 21 and 286, and the U.S. Comptroller of the Currency (various years).

The data are from 1931, the year when the largest number of banks with securities operations failed. For all other years, only one or two of these banks closed. The logit estimates are presented in Table 1. With the exception of the two ratios representing bond holdings, the coefficients had the expected signs. The coefficient on the dummy variable for a security affiliate was negative and significant, indicating that the presence of an affiliate seems to have reduced the probability of bank failure. For the coefficient on the bond department variable, the null hypothesis that the coefficient was equal to zero could not be rejected. This result may be explained by the fact that securities operations were a matter of degree not kind. Almost all banks engaged in some securities activities and the banks singled out by the bond department dummy variable were prominent only by their inclusion in a register of leading dealers. Security affiliates, on the other hand, could engage in many more activities, especially the sale of stocks. The logit estimates suggest that any type of securities operation did not increase the probability of bank failure. Furthermore,

TABLE 1
Bank Failures and Security Affiliates
Logit Estimates

Variables	Model
Intercept	1.0478**
	(0.6852)
Capital/assets	−1.7212*
	(0.8015)
U.S. Government bonds/assets	1.5301*
	(0.7361)
Other bonds/assets	0.3504
	(0.5308)
Loans/assets	1.2645*
	(0.5738)
Cash items/deposits	−4.4362*
	(1.2072)
Deposits/assets	−1.2718*
	(0.8831)
Bills payable and other liabilities/assets	3.3927* (1.0017)
Security affiliate dummy	−0.9143*
	(0.4930)
Bond department dummy	0.1081
	(0.4807)
Likelihood ratio test	19.97*

Note. The number in parentheses are estimated standard errors.

Source. See text and White (1984a).

* Significant at the 0.05 level.

** Significant at the 0.10 level.

the presence of a security affiliate and whatever characteristics were associated with it tended to reduce the likelihood of failure.

2. *Was Investment Banking Favored over Commercial Banking?*

Congressional investigators were convinced that commercial banks had suffered because management favored securities activities at the expense of commercial operations. This problem could have arisen if the ownership structure of the firms created a conflict of interest prejudicial to commercial banking. Conflicts of interest are possible whenever an individual or an institution is serving two interests and may better one at the expense of the other. If all types of financial intermediation were conducted within the bank, then there would be no ordinary incentive for managers to favor one line of business over another. To do so would only shift the source of stockholders' income (Edwards, 1979). The separation of activities between a bank and its affiliate created a potential conflict of interest if the ownership of the affiliates differed from that of the parent banks. Divergence of ownership would give managers an opportunity to favor one group of stockholders over another. They could have favored the securities business by shifting resources through loans and other devices from the banks to their affiliates.

In the sole major study of bank affiliates (Peach, 1941, pp. 130–131), only three minor examples of divergent ownership were discovered. I have found one additional example, the First Mechanics National Bank and the First National Company of Trenton, New Jersey, where there was a different set of stockholders for the bank and the affiliate.[6] However, divergence of ownership appears to have been the exception rather than the rule. Although there is no complete survey of the ownership, most affiliates, especially the leaders in the industry, appear to have been ratably owned either directly by stockholders or through the trusteeship of affiliate stock (U.S. Senate, 1932). The incentives for managers to favor investment over commercial banking thus seem to have been minimal as all but a few affiliates were ratably owned.

3. *Dangerous Swings in Earnings or Safe Diversification?*

Securities affiliates were considered by critics as dangerous to banks because of the sharp swings in their profits and losses, which might injure parent banks. This view derived from the observation that the swings in earnings and losses in investment banking were much larger than those in commercial banking. Bank managers, it was feared, would be tempted to come to the aid of their securities affiliates in bad times, thereby weakening the banks. This would have been particularly serious if their earnings cycles were highly correlated. A potential threat to a commercial

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[6] The bank had total assets of $46 million and its affiliate $270,000.

bank could have existed if the variance of earnings or profits from an affiliate greatly increased the variance of the combined earnings or profits of the bank and its affiliate (Edwards, 1979). Whether the higher variability of the securities business significantly increased the overall variance depends on the covariance between commercial and investment banking.

To examine this relationship and other charges leveled at securities affiliates in the Congressional hearings, I have collected balance sheet and income data for national banks and their affiliates. I have excluded state-chartered and private banks and their affiliates only because there appears to be relatively little information on them. Data for all affiliates are scanty because they were not required to provide regular statements. The names of the national affiliates in the securities business were culled from the February 1929 issue of *Security Dealers of North America*. Data for affiliates were obtained from *Moody's Manual of Investments* from 1926, when this publication first began comprehensive lists of financial institutions, to 1932. Eighteen national banks with security affiliates (or 17% of all national bank affiliates) were identified. These banks and their affiliates are listed in Appendix A. Over the 7-year period, this provided 69 observations. Not every bank and affiliate gave all the necessary information every year, so often the number of observations on a variable are fewer than 69. Income data for banks came from *Moody's*. In order to ensure standardized reporting practices, the balance sheet data for banks was drawn from the Comptroller of the Currency's *Individual Statements of Condition of National Banks*. The banks and their affiliates appear to be a representative cross section of the population, including large, medium, and small firms from all parts of the country.[7]

These data permit an examination of the relationship between the earnings of a bank and its affiliate to determine whether securities operations tended to magnify swings in total bank income. Table 2 provides information on the mean, variance, and covariance of rates of return for banks and their security affiliates. Four different measures of the rate of return are given: profits to capital, profits to total assets, earnings to capital, and earnings to total assets. As expected, the mean and standard deviation of the return for the affiliates was higher than for the banks. When the standard deviation is standardized by the mean, the affiliates display a higher degree of risk. The covariances are small and the coefficients of correlation between the various measures of return for the banks and security affiliates are small and insignificant in all cases.[8] Although it is difficult to draw strong conclusions from a small sample, downturns in bank earnings do not appear to have regularly coincided with declines in affiliate earnings. Danger from a cyclical downturn in the securities business for a bank with an affiliate was not necessarily serious.[9]

The movement of banks into the securities field represented an effort by them to diversify their activities beyond those strictly allowed to them by law. The efficient frontier for risk and return for the stockholders' combined "portfolios" of investments in banks and securities affiliates is shown in Fig. 1. Here the shareholders' risk and return vary as the proportion of a firm's resources devoted to commercial and investment banking change. Return is measured here as profits to capital for both institutions.[10] The flatness of the frontier reflects the weak correlation between the rates of return on the two financial activities. In light of the

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[7] The relatively small number of observations and the means by which the data was collected may give rise to the suspicion that the data is self-censored; that is, the affiliates responsible for the worst abuses avoided any public reports. Although this may be a problem, the observations do include several affiliates, notably the Chase Securities Corporation, that were specifically criticized by the Senate Banking Committee.

[8] This analysis pooled the data over several years for a number of banks. The number of observations for a single bank were few, the maximum being five.

TABLE 2

The Rate of Return on Banks and Their Security Affiliates, 1926–1932

Variables	Number of observations	Mean	Standard deviation	Standard deviation divided by the mean
Bank profits/bank capital	23	0.0840	0.0341	0.4060
Bank profits/bank assets	23	0.0093	0.0033	0.3548
Bank earnings/bank capital	19	0.4667	0.1043	0.2235
Bank earnings/bank assets	19	0.0490	0.0025	0.0510
Affiliate profits/affiliate capital	23	0.1738	0.1291	0.7428
Affiliate profits/affiliate assets	23	0.0665	0.0539	0.8105
Affiliate earnings/affiliate capital	19	0.4710	0.4016	0.8527
Affiliate earnings/affiliate assets	19	0.1629	0.1551	0.9521

Variables	Number of observations	Covariance	Correlation coefficient (probability in tail)
Bank profits/bank capital–affiliate profits/affiliate capital	23	0.00068	0.1552 (0.4796)
Bank profits/bank assets–affiliate profits/affiliate assets	23	0.00001	0.0154 (0.9445)
Bank earnings/bank capital–affiliate earnings/affiliate capital	19	0.00363	0.0867 (0.7242)
Bank earnings/bank assets–affiliate earnings/affiliate assets	19	0.00011	0.2726 (0.2588)

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[9] A contemporary comparison (Dudley, 1984) of bank holding companies and large investment banks yielded similar results. It found that the after tax rate of return on equity for investment banks was almost double that for bank holding companies. Noting an inverse relationship between corporate bond issues and new commercial and industrial loans for 1975–1983, the authors argued that combining commercial and investment banking could reduce earnings volatility.

[10] For an example of an application of this analysis to modern bank holding companies, see Meinster and Johnson (1979).

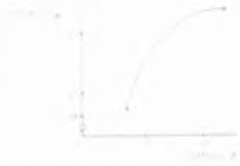

FIG. 3. The efficient frontier for National banks with security affiliates.

intense criticism of securities affiliates, it is interesting to note banks' moderate degree of diversification. For 1930, the maximum percentage of combined capital in a security affiliate was 27.9% for the First National Bank and Trust Company and First National Rochester Corporation of Rochester, New York. For the largest firms in sample, Chase National Bank and Chase Securities Corporation, the figure was 22.8%. A few banks had less than 5% while the average was approximately 10%. This puts all banks at the lower end of the frontier. On the efficient frontier, if a bank had no securities affiliate, its return was 0.084 and the standard deviation was 0.034. If 20% of its capital were devoted to security operations, its portfolio return would rise substantially to 0.102 and its risk increase only slightly to 0.037. Even though banks had taken over a significant fraction of the total investment banking industry, this diversification does not seem to have threatened wider fluctuations in the combined earnings of all a bank's activities or substantially increased portfolio risk.

4. *Was the Solvency or Liquidity of Commercial Banks Endangered?*

One empirical study of security affiliates was conducted by Jules I. Bogen (1935), an associate advisor to the Senate Banking Committee and Professor of Finance at New York University. Bogen tried to provide concrete evidence to support the committee's complaints about the affiliate system.[11] He argued that commercial banks were vulnerable because their security affiliates were dangerously undercapitalized and dependent

on borrowed funds.[12] He was particularly critical of what he regarded as the high level of unsecured loans made by parent banks to affiliates. For the nine banks Bogen examined in 1919, only 2.7% of $58.5 million of loans to affiliates were not secured. For a slightly different group of nine banks in 1930, he found that 18.9% of $109.2 million of loans were unsecured. It is difficult to interpret these ratios as they reflect different banks and changed economic circumstances, but they do not favor Bogen's interpretation of a heavy dependence on unsecured credit.[13]

Bogen also believed that he had discovered evidence that the affiliates were undercapitalized, pointing to the size of each affiliates' aggregate yearly syndicate participations relative to its capital and surplus. However, this measure overstates the risk because syndicates were very short-lived, making exposure to risk at any point in time limited. In addition, Bogen worried that the decline in the market value of most affiliates' portfolios in his sample for 1930 exceeded their earnings. He maintained that if the affiliates reduced the value of their capital to reflect this decline a substantial fraction of capital would disappear. Bogen was straining to make a case by claiming that this was an indication of weakness as all the affiliates he observed had sufficient capital to survive the stock market's plunge—more certainly a sign of strength.

The Senate Banking Committee's arguments are thus not well supported by Bogen's study. To give a more rigorous examination of the effects a security affiliate might have on the capital adequacy and liquidity of the parent banks, the information collected for this paper is analyzed using multiple regression. By design, only data on banks with affiliates were included. It was not possible to devise an approach that evaluated the capital and liquidity positions of banks that had and did not have security operations because almost all banks were involved to some degree and there is no means to separate the two groups. By selecting firms where commercial and investment banking were divided into separate departments, the degree of involvement in securities operations can be measured.

One of the key issues raised explicitly or implicitly by most critics was the effect of the affiliates on bank capital. The determinants of bank capital are complex, but the key factors can be captured in a simple model.[14] The two measures of capital adequacy used were capital to total

assets and capital to loans and discounts. One factor influencing these ratios is the presence of economies of scale in the banking industry. The larger a bank, the more numerous and diversified its loans may be, and thus the less capital it may require. A variable, the natural logarithm of total bank assets, was included to capture any nonlinearities in these economies of scale. A bank would have needed more capital, the higher the proportion of risk to total assets. Risk assets were measured as total assets less cash, items in process of collection and balances due from other banks. Peltzman (1970) has argued that capital is an input in the production process and a means to attract deposits. If the faster growth of deposits, measured as the change in deposits over the previous year, triggered higher levels of capital, then there should be a positive relationship between the two variables. In this period, bank earnings were virtually the sole source of additional bank capital. The higher the earnings to total assets, the more easily a bank may have been able to increase its capital. Dummy variables for 6 of the 7 years were included to capture the effects of any changes over time.

Two measures of the effects of security affiliates on bank capital were employed. The first, the ratio of total affiliate assets to all bank and affiliate assets, gives the relative size of an affiliate to a bank's other activities. If a larger proportion of investment banking activities lowered the capital ratios, the sign on this variable should be negative. The second measure, the ratio of the security affiliate's capital to its total assets represents its own exposure to risk. This variable also captures what Bogen wanted to investigate as it represents the degree to which affiliates were undercapitalized and dependent on borrowed funds. If higher affiliate capital caused a drain on bank capital, this variable should have a negative sign.

Tables 3 and 4 report the OLS regression results. Models were tested with and without the earnings variable because significantly fewer banks provided information on earnings. The models performed fairly well in explaining the variation in the capital adequacy variables. The first three variables had the expected signs and most were significant. There appears to have been some economies of scale, more risk assets tended to increase bank capital, and faster deposit growth raised capital. For earnings variable, the hypothesis that the coefficient was different from zero could not be rejected in all models. The dummy variables captured the sharp rise of the capital ratios in the early 1930s as banks tried to improve their capital positions in the midst of the depression.

The presence of security affiliates appears to have had no deleterious effects on bank capital. Capital ratios did not decline, the larger affiliates were relative to their parent banks. The coefficient was positive but insignificant in three cases and positive and significant at the 10% level in the fourth, suggesting that banks may have slightly increased their

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[11] Unfortunately, Bogen's data cannot be used as a basis for further study. Anonymity of affiliates and banks was maintained and the data were presented bit by bit so that income and balance sheets cannot be reconstructed.

[12] Bogen asserted that security affiliates operated with a higher proportion of borrowed funds than unaffiliated investment banks. Looking at eleven affiliates, he found that 64% of their funds came from capital accounts and 36% were borrowed. This is similar to my sample where the average capital to total assets ratio was 54%. There is no means for testing his assertion as almost all investment banks were partnerships which rarely, if ever, released information on their operations.

[13] This concern about unsecured loans has been translated into law in Section 23A of the Federal Reserve Act that now requires bank loans to affiliates or subsidiaries to be fully secured.

[14] Similar analyses of bank holding companies have been conducted by Jessee and Seelig (1977) and Rose and Rutz (1981).

TABLE 3
The Capital Adequacy of National Banks with Security Affiliates
(Dependent Variable = Bank Capital/Total Bank Assets)

Variables	Model I	Model II	Model III	Model IV
Intercept	0.1484	0.1274	0.0299	0.0821
	(0.1160)	(0.1092)	(0.0564)	(0.0631)
log Total bank assets	-0.0146*	-0.0151*	-0.0066	0.0011
	(0.0071)	(0.0068)	(0.0022)	(0.0025)
Bank risk assets/total bank assets	0.1896	0.2244*	0.1609*	0.1396*
	(0.0945)	(0.0864)	(0.0711)	(0.0591)
Growth of bank deposits	0.0772*	0.0609*	0.0106	0.0231
	(0.0284)	(0.0280)	(0.0196)	(0.0246)
Bank earnings/total bank assets	1.2272	1.2890		
	(0.9566)	(0.8826)		
Affiliate assets/combined assets		0.2973**		0.0629
		(0.1406)		(0.0882)
Affiliate capital/affiliate assets	0.0019		0.0289*	
	(0.0166)		(0.0111)	
Dummy 1927	0.0017	0.0024	0.0007	0.0026
	(0.0177)	(0.0146)	(0.0137)	(0.1452)
Dummy 1928	0.0001	0.0002	0.0015	0.0064
	(0.0152)	(0.0144)	(0.0126)	(0.0136)
Dummy 1929	0.0141	0.0101	0.0050	0.0132
	(0.0165)	(0.0156)	(0.0135)	(0.0144)
Dummy 1930	0.0294**	0.0259**	0.0235*	0.0328*
	(0.0155)	(0.0146)	(0.0136)	(0.0137)
Dummy 1931	0.0292	0.0273	0.0167	0.0281**
	(0.0180)	(0.0169)	(0.0149)	(0.0156)
Dummy 1932	0.0111	0.0144	0.0204	0.0329**
	(0.0177)	(0.0205)	(0.0151)	(0.0165)
R^2	0.5527	0.6078	0.5026	0.3257
F statistic	3.55*	4.37*	5.65*	2.75*
Number of observations	43	43	68	68

Note: The numbers in parentheses are estimated standard errors.
* Significant at the 0.05 level.
** Significant at the 0.10 level.

capital positions in the presence of an affiliate. The coefficient on the affiliate to capital asset ratio was positive and in three cases significant. This positive relationship does not imply any shifting of risk from one activity to another. Instead, it may represent a characteristic of managerial preferences. Those banks with higher capital ratios may also have wanted higher capital ratios for their affiliates. Security affiliates thus do not in any conventional sense seem to have systematically impaired the capital adequacy of their parent banks.

Another possible source of trouble would have been if security affiliates had endangered the liquidity of banks, making them more prone to a panic. This might have happened if banks had been forced to take securities issued by their affiliates that had fared poorly or had given the affiliates excessive loans. One measure of bank liquidity is the ratio of cash, items in process of collection and balances due from banks to total deposits. This represents all the funds immediately available to pay out to depositors.

The size of a bank would again be a determinant of the liquidity ratio. The larger the bank, the more numerous and varied its depositors. This would tend to decrease unpredictable changes in deposits and allow a bank to operate with a lower degree of liquidity. There is another factor related to size that would tend to increase the liquidity ratio. Correspondent banking in the United States led many country banks to place deposits in city banks. In turn, many of these banks put funds in the money-center banks (White, 1983, pp. 99–107). This pyramiding of bankers' balances was further encouraged by state bank reserve requirements. It is not possible a priori to determine which of these two factors was more important. The growth of deposits over the past year was included as an indication of some degree of the variability of deposits, and dummy variables were again employed for time effects.

TABLE 4
The Capital Adequacy of National Banks with Security Affiliates

Variables	Model I	Model II	Model III	Model IV
Intercept	0.4509**	0.5065**	0.0951	0.1763
	(0.2300)	(0.2561)	(0.1224)	(0.1413)
log Total bank assets	-0.0370*	-0.0451*	-0.0129*	-0.0138*
	(0.0104)	(0.0105)	(0.0046)	(0.0055)
Bank risk assets/total bank assets	0.1878	0.3107	0.2395*	0.1819
	(0.1945)	(0.2020)	(0.1137)	(0.1320)
Growth of bank deposits	0.0880	0.1290*	0.0504	0.0701
	(0.0544)	(0.0562)	(0.0412)	(0.0466)
Bank earnings/total bank assets	-1.6525	-2.3395*		
	(1.9606)	(2.0606)		
Affiliate assets/combined assets		0.0401		0.0525
		(0.1286)		(0.1900)
Affiliate capital/affiliate assets	0.0744*		0.0968*	
	(0.0342)		(0.0279)	
Dummy 1927	0.0113	0.0142	0.0081	0.0140
	(0.0370)	(0.0344)	(0.0284)	(0.0326)
Dummy 1928	-0.0647	-0.0064	-0.0050	0.0108
	(0.0314)	(0.0337)	(0.0266)	(0.0311)
Dummy 1929	0.0266	0.0336	0.0019	0.0267
	(0.0340)	(0.0366)	(0.0279)	(0.0326)
Dummy 1930	-0.0644*	-0.0772**	-0.0528**	-0.0812**
	(0.0320)	(0.0343)	(0.0269)	(0.0306)
Dummy 1931	-0.0892*	-0.0939*	-0.0636*	-0.0976*
	(0.0371)	(0.0390)	(0.0308)	(0.0358)
Dummy 1932	-0.1166*	-0.1231*	-0.1038*	-0.1412*
	(0.0447)	(0.0480)	(0.0320)	(0.0371)
R^2	0.5681	0.5407	0.6005	0.4766
F statistic	6.22*	5.03*	8.57*	5.19*
Number of observations	43	43	68	68

Note: The dependent variable was bank capital/loans and discounts. The numbers in parentheses are estimated standard errors.
* Significant at the 0.05 level.
** Significant at the 0.10 level.

Four measures of the influence of securities affiliates were tried. The ratio of affiliate to all bank and affiliate assets was the first. If a relatively larger affiliate reduced the liquidity ratio, this variable should have a negative sign. A liquidity measure for affiliates was constructed by dividing their cash assets by their noncapital liabilities. If the affiliate were given preferential liquidity, the sign of this variable should be negative. Another measure was the affiliate's borrowed funds divided by its cash assets. A negative sign on this variable was expected if excessive borrowing relative to cash caused a fall in the parent bank's liquidity. The last measure of an affiliate's influence was its noncapital liabilities to its parent bank's loans and discounts. Although not all an affiliate's borrowing would have come from its parent bank, this variable attempts to capture the dependence on borrowed funds that concerned Bogen.

The results of these regressions are presented in Table 5. In all models the larger the size of the bank, the significantly higher the level of liquidity, indicating that the pyramiding of bankers' balances was the more important factor. The change in deposits was insignificant in all models. The annual dummy variables were all negative and often significant, reflecting the lower levels of liquidity typical of the banking industry after 1926.[17]

The ratios measuring the relative size of the affiliate, the affiliates' liquidity, and the affiliates' noncapital liabilities to bank loans were all weak as explanatory variables. It was not possible to reject the hypothesis that the coefficients on these variables were equal to zero. Only the ratio of the affiliates' borrowing to cash assets was significant at the 10% level. It had a positive sign, suggesting that banks increased their liquidity when their affiliates' borrowings rose faster than cash assets. National banks' liquidity does not appear to have been weakened by the presence of an affiliated securities business. Congressional hearings did find numerous links between banks and their affiliates, but the activities of security affiliates did not adversely affect commercial banking operations, nor did managers favor the affiliates at the expense of the banks.

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[17] The currency to deposit ratio for all national banks was 0.241 in 1926 and the average for 1927–1932 was 0.215. These ratios were calculated from U.S. Department of Commerce (1974), pp. 1025–1026.

CONGRESS MAY HAVE OVERREACTED

The **Chairman**. I'd like to ask both you gentlemen, Mr. Perkins and Mr. Ritchie, to comment on Mr. Kelly's paper on the legislative history of the Glass-Steagall Act where he says:

> The legislative history of Glass-Steagall is a story of a theory carried along by events. Standing alone, Senator Glass' theory of sound banking practice was not sufficiently persuasive to secure enactment of the divorce provisions. The theory needed the support provided by the collapse of the banking system and the damaged reputation of the financial community. This conclusion suggests that Congress may have overreacted to the events of the depression.

I want to know whether you agree or disagree, Mr. Ritchie.

Mr. **Ritchie**. Well, I would agree that the events of the depression really brought this law to the front and the events of the Pecora investigation enabled the Congress to pass it and the President to sign it. President Roosevelt was very reluctant to support this bill. I would definitely agree that what had happened between 1929 and 1932 had a great impact on it, although as I said in my statement the proposals go back 20 years before this and were talked about by both conservatives and liberals during the 1920's. President Hoover also shared some of these feelings, as well as President Roosevelt.

I don't think they were strictly concerned with the idea that the securities affiliates had caused the failures of these banks, but I think they believed that the securities affiliates had caused the overheating of the stock markets during the 1920's and it prevented the Federal Government from taking control of the situation.

The **Chairman**. Do you conclude this was an overreaction?

Mr. **Ritchie**. No, I don't think it was an overreaction. I think they had very good reasons for passing the legislation that they did.

The **Chairman**. Mr. Perkins?

Mr. **Perkins**. I think it was an overreaction, although it was one that was understandable because you need to remember this was before the FDIC was enacted. This was before the SEC. This occurred before a whole series of new laws were passed by Congress and new techniques or safety devices were approved by securities firms themselves.

So that I think, in a sense, there was no unanimous opinion at the time. There were events, personalities, to cause the scales to tip at the last minute in some ways. I would agree with Mr. Ritchie that that was true. It was in the air. It could have gone one way or the other. Glass was the chairman of the committee. He was strongly in favor of divorce. He had been strongly in favor for years, and everybody knew where he stood. And when events came to pass where he could put his stamp on this bill in the way he wanted, that was the final outcome.

I think, also, President Roosevelt's support was helpful, because President Roosevelt had come to the conclusion, as a result of his experience as Governor of New York, when many of these investigations were ongoing, that financial integration was a threat to the safety of commercial banks.

I think this was the main concern at this time. It was not a worry about conditions in the securities industry. It was about whether investment activities were even the slightest little threat to commercial banks? And if the answer was, yes, it was a minor little threat, then let's remove it.

The CHAIRMAN. Thank you. My time is up.

Senator Bond.

Senator BOND. Thank you very much, Mr. Chairman.

I certainly find the historical perspective on Glass-Steagall to be of interest and we appreciate the testimony that you have provided.

Nevertheless, I might just ask, the question occurs to me, why are we discussing debates that took place 50 years ago under circumstances that are vastly different than those today? Do any of you feel that the same arguments are applicable today that were relevant 50 years ago?

Mr. PERKINS. I don't think so. I think they are almost all out of date. I think the old theory, as I said originally, was that commercial banks were based on the real bills theory that all loans, or a substantial part of them were to be 90-day loans, and this is no longer true with the emergence of term loans and a whole host of other different kinds of commercial banking activities.

I think the whole financial services market has changed so substantially that most of these arguments put forth in the late 1920's and early 1930's are pretty much out of date.

Senator BOND. Mr. Ritchie?

Mr. RITCHIE. Senator, I would say as an historian I don't believe that history is a straitjacket, but it's good for educational purposes, and I think that I would recommend in terms of deregulating anything that the Congress should be aware of why it was regulated in the first place. There was an attempt to stop abuses that were prevalent in the decade before 1933 that were enacted in this legislation. I would just hope that whatever legislation came out of this would be sure that the abuses that existed before that were not reestablished.

Senator BOND. In other words, you subscribe to the theory that those who fail to study history are destined to commit the same mistakes again rather than the theory that the only lesson that history teaches is that history cannot teach us any lessons?

Mr. RITCHIE. My favorite quotation is from Mark Twain, who said, "History doesn't repeat itself, but it rhymes." [Laughter.]

Senator BOND. Mr. Kelly?

Mr. KELLY. Senator, I think the important point is to distinguish between the abuses that existed in the 1920's that were real and that were common to the securities industry as a whole. Those abuses were in fact addressed by the Securities Act of 1933 and the Securities Exchange Act of 1934, which created a regulatory structure which didn't exist in the 1920's and wasn't in place to prevent some of the abuses that Mr. Ritchie has cited.

Mr. Ritchie has also spoken of the question of restructuring the regulation of the financial services industry in terms of deregulation. I think it's fairly clear, at least as I understand the current proposals, that any expanded securities activities would be conducted in a separately capitalized bank holding company subsidiary that would be insulated from the bank by the provisions of the Banking Act of 1933 other than Glass-Steagall.

So I think I agree with the thrust of your question, Senator.

Senator **Bond**. Thank you. Mr. Ritchie, I think your testimony suggests that Senator Glass had for years believed that banking and securities activities should be separated and had previously introduced several pieces of legislation to accomplish this.

Can you shed any light for us on the origins of his belief?

NO BANK EXAMINERS

Mr. **Ritchie**. I think it really came out of his observations of events in the 1920's. It's interesting that his first bill that he introduced in 1933 only called for the securities affiliates to file official reports. It's important to remember that the securities industry in the 1920's was an entirely private operation. The New York Stock Exchange was compared to a private club in those days and there were no bank examiners who ever went into the Morgan Bank to ever look at their books.

Congress had no way to find out what these banks and securities affiliates were doing, so Glass' first bill was just that they should provide reports. That was 1930. By 1931, he had come to the conclusion that reports would not be necessary, they should separate the functions completely. But I think it was the lack of knowledge and the lack of control that worried the Congress and worried somebody like Senator Glass most in the period before 1933.

Senator **Bond**. Mr. Perkins, did you want to comment on that?

Mr. **Perkins**. Yes. I think the origins of his ideas probably go all the way back to the Federal Reserve Bank System because he was very instrumental in drafting that legislation. He had been involved in banking legislation for almost 30 years.

Mr. Ritchie is correct that at one time Glass was considering not just separation but the possibility of simply having oversight over the banks' securities affiliates. At least one or two witnesses that came before his committee recommended that the two functions be continued so that way there could be oversight. In other words, there was some feeling that mere regulation might be a possible alternative.

Both ideas were in the air and in the end it came down to divorce because of the facts that came out about the stock market; Glass just decided investment banking was so corrupt that nothing that could be done to protect commercial banks—so just get rid of the security affiliates. But the other alternative was certainly proposed and one of the options that he was weighing.

Senator **Bond**. Thank you, gentlemen. I've found your comments most helpful and most interesting.

Thank you, Mr. Chairman.

The **Chairman**. Senator Wirth.

Senator **Wirth**. Thank you, Mr. Chairman.

If I understand what all of you have said, prior to 1933 there was no separation between commercial banking and investment banking. Is that right?

Mr. **Perkins**. Well, there originally was, but the system evolved. It came about through the origins of trust companies in the late 19th century. Trust companies emerged which held general charters. They started conducting commercial banking, supervising trusts, and investment banking. In order to compete with trust companies, the National Banking Act was liberalized so that over a period of time, by the 1920's, for all practical purposes, your assumption is accurate.

Senator WIRTH. Then this separation came about with the passage of Glass-Steagall in 1933?

Mr. PERKINS. Right. There was some belief that the fact that these markets had become very integrated in the middle 1920's had been one cause of the depression. In other words, there was some circumstantial evidence.

Senator WIRTH. The debate goes back to the progressive era, and the depression experience?

Mr. PERKINS. Correct.

Senator WIRTH. Then in 1935, as I understand it the Congress was beginning to back off and would have backed off, I gather the evidence suggests, had it not been for the threat of a veto by President Roosevelt. Is that correct?

PRESSURE FOR CHANGING GLASS-STEAGALL ACT

Mr. RITCHIE. I think there was also very strong support in the House of Representatives against amending the bill. The Senate might have been more in favor but the House always had a more populist view.

Senator WIRTH. What kind of debate occurred in that 50-year period of time between 1935 and 1985 and is the debate similar to that we have going on today? Has there been a continuum of pressure from the financial institutions for changing Glass-Steagall, or has that peaked within the last 4 or 5 years?

Mr. PERKINS. I think it has peaked. For the first 40 years, let's put it this way, there was a general acceptance that separation was a political fact of life—changing the law was just impossible—thus people accepted it. And then, as the financial services industry began to get more integrated in general, then I think there became pressures to——

Senator WIRTH. It doesn't make a lot of sense to me that you would have a lot of pressure in 1935 to back off Glass-Steagall and then suddenly that stops and for 40 years there's no pressure to back off Glass-Steagall? That doesn't seem to be consistent with my understanding of what happened.

Mr. PERKINS. First of all once people understood that President Roosevelt was opposed; then the stock market started to revive a little bit in the 1930's and the fear that there was more energy needed in investment banking seemed to change. Many new firms were organized, new investment banking firms, in the 1930's. The economy began to revive and the pressure eased. Also, the investment bankers who had started new firms decided they prefer not to have competition from commercial banks anyway.

Mr. KELLY. Senator, I agree with Mr. Perkins' last point. I think one point, Senator, going back to 1935, is that Senator Glass realized in 1935 that he had failed to recognize the importance of the securities markets. I think, as Mr. Perkins suggests, that as the economy recovered and as the securities markets got stronger and as more commercial lending business developed for the banks, the pressure eased. And the extent to which Congress has addressed Glass-Steagall in the last 50 years has been in a discrete rather than comprehensive fashion. The statute books shows a series of amendments to section 16, for example, authorizing banks to underwrite different sorts of quasi-governmental securities.

But I think probably the greatest impetus recently has been changes in the market. It's been the securitization basically of credit. The fact is that the credit markets have changed and it's created an impulse on the part of the banks, since the activities are closely related to their core business, to be able to participate. And it's consistent with Senator Glass' acknowledgment that the securities market is an important way to transmit credit.

Senator WIRTH. It seems to me we have conflicting objects. On the one hand, we seek a set of values emphasizing competition and efficiency. The other set of other values which are safety and soundness, fairness, equity, and access to capital, arm's length relationship, and lack of conflicts of interest. I think that the chore that we face is, can that latter set of values be reconciled with the first, which is really what you were getting at in talking about the changing nature of the marketplace. As that market changes, is the change in that market consistent with those other values? That's ultimately what we have to do.

I found your testimony and that history very helpful. Thank you all very much for being here.

The CHAIRMAN. Senator Sanford.

Senator SANFORD. Thank you, Mr. Chairman. I would like to put an opening statement in the record.

The CHAIRMAN. Without objection, it will be printed in full in the record.

Senator SANFORD. I'm delighted that we are looking at this particular point because I think we need to have a clear feeling of where we go as we look at stronger legislation that will provide safe and orderly and competitive banking and investment business. So I thank you for all of your work in preparing to come and give us the benefit of your information.

I heard Mr. Kelly say that section 20 was prepared rather hastily and without much data by the Federal Reserve and that, in all likelihood, Mr. Aldrich, the chairman of Chase, was motivated by a desire to do in Morgan. Is that pretty much the history? If so, maybe we shouldn't have enacted the Glass-Steagall provisions in the first place.

Mr. KELLY. Well, Senator, I think you have accurately described section 20. It was reluctantly proposed by the Federal Reserve Board. And with respect to Mr. Aldrich, I think there is a consensus among people who have written about the period that it was an assault on J.P. Morgan. Morgan, as a private bank, was one of the Chase National Bank's principal competitors.

The other factor that one must keep in mind about Mr. Aldrich's announcement that he was going to sever Chase's ties with its securities affiliate is the fact that the securities business had declined considerably. I think in fact it had gone down 95 percent between 1929 and 1933.

The fact was that Mr. Aldrich had an affiliate that he probably no longer needed that was causing him considerable political problems.

Senator SANFORD. So he got out while he could?

Mr. KELLY. Yes, sir.

Senator SANFORD. Well, now, your histories were fascinating, but you didn't really bring up modern history. You haven't talked about the effect in the last 30 years.

Mr. RITCHIE. I'm afraid, Senator, my research was strictly in the 1930's.

Senator SANFORD. But have you any comment on the effectiveness in the last 20 years?

Mr. RITCHIE. I'm really not an expert on that, Senator.

Senator SANFORD. Well, Mr. Kelly, I know you are an expert or you've been working on this a long time. Are there any valid reasons for caution in joining investment and commercial banking?

Mr. KELLY. Well, Senator, I think I would focus on what you mean by "joining." I think to the extent that banks' securities activities or bank holding companies' securities activities are conducted in a separately capitalized bank holding company affiliate, subject to SEC regulation, I think the concerns about deregulating financial markets more or less disappear insofar as the securities company would be separated from the bank regulated functionally.

In that light, I'm not sure that I can think of any valid reasons for not joining investment and commercial banking.

Senator SANFORD. Do you think the SEC can adequately regulate a company within a holding company?

Mr. KELLY. Yes, sir, I believe so.

Senator SANFORD. Do you think it needs any additional powers or additional regulations to do its job adequately?

Mr. KELLY. Well, I would be hesitant to comment on that, Senator, without having explored that particular question more carefully. I think it is fairly clear that the regulatory structure in place is adequate. Now whether there have to be changes at the margins or not, I don't think I should comment on that at this point. That would take a longer response which I would be glad to supply.

MANY ABUSES IN THE INVESTMENT BUSINESS

Senator SANFORD. Well, we probably shouldn't go forward with this without a clear understanding of whether or not SEC can handle the job. They certainly have done a fair job I think, but we've seen a great many abuses in the investment business recently, and the concern now is that the SEC is taking more and more of a hands-off attitude toward its responsibility. It seems to me that that raises a lot of dangers that ought to be confronted.

You're saying, I suppose, that we ought to be very careful that SEC has adequate authority?

Mr. KELLY. Yes, sir. I'm saying that I think regulation is important and I don't think anyone is proposing that the industry be deregulated. The fact is that even in 1933, Congress had put a regulatory structure in place which addressed many of the concerns they had at the time.

Senator SANFORD. Well, thank you very much. My time is up.

The **Chairman**. Thank you, Senator Sanford.

Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman. I apologize for my late arrival and if my questions cover areas that have already been discussed I will read the record.

AMERICAN TRADITION VS. EUROPEAN TRADITION

I've been interested in what appears to be the division of treatment of this issue between the American tradition and the European tradition.

I would be interested in any comments that you might be able to make on what has been the European practice over the same time period that we've been discussing in terms of our own economic history?

Mr. **Perkins**. I'd like to comment on that. Maybe somebody else wants to add something.

I think the following is a bit of an oversimplification but I'll do it anyway. There was the British tradition that separated commercial and investment banking, not I believe by statute, but simply by tradition. Then the other general organizing system was the German system on the continent, which I'm most familiar with. In Germany there was little separation of functions. Banks did commercial or investment banking, or any financial service that seemed appropriate.

And those two systems developed beside each other and thrived. There are many ways to perform financial services. If you look at it as a historian, you can see various systems. There are many ways to make a financial system work, and those were the two basic systems in place from the late 19th century forward, almost in some ways, up to the very present. It's only in the last few decades that the British have started to turn toward more integration.

Senator **Graham**. Does anyone else wish to comment on that question?

Mr. **Kelly**. Senator, if I could address that, it's been pointed out by some people with I think a fair amount of accuracy that Senator Glass misunderstood what the British system involved. For years in Britain there had been merchant banks, which are very similar to the private banks in the United States at the turn of the century and up until 1933, which in fact took deposits from corporations and from what we would call today high net worth individuals, and in fact participated in the securities markets.

As the middle class began to rise in Britain, the clearing banks came into existence and at least initially the clearing banks simply took deposits from the public and weren't involved in the capital markets.

I think Senator Glass may have focused on the rise of the clearing banks rather than on the merchant banks. The fact is that in London today, the clearing banks are involved in a full range of activities and the merchant banks still exist as a separate aspect of the financial services industry.

Senator **Graham**. One of the factors which is driving this discussion today is the increasing internationalization of the American economy and the argument that our dissimilarity to European competitors has put our financial institutions at a disadvantage.

I am intrigued with the fact that you say that two parallel systems existed as between Great Britain and continental Europe. What types of frictions and accommodations were developed between those two dissimilar approaches to this issue?

Mr. **Perkins**. I'm not so sure there were any frictions. They just simply operated in parallel as long as markets tended to be narrow and small on the continent. There's no doubt that London became a dominant banking center with a separated system. This was another reason perhaps that Glass tended to look so favorably on the English model. London had done well by dividing functions and so it seemed that if London could make it work, then the United States could make it work as well.

But conditions have changed since the 1930's, and London is no longer what it used to be. It's become a worldwide capital market, not just a London-New York market. These new developments have caused the frictions that you might be referring to. But times have changed, and it is a bigger world with more participants. There has been a greater tendency in other countries to integrate financial services. So that separation has become an impediment to the United States.

Mr. **Kelly**. Senator, if I could just point out again, the fact is that in Great Britain in the 19th century and throughout the 20th, there have been merchant banks, which took deposits and underwrote securities, which were very similar to German banks. It wasn't as if the British system completely separated commercial and investment banking.

Mr. **Perkins**. Mr. Kelly is right, but these merchant banks didn't accept deposits from the general public. So it was very different. There was a very small clientele of depositors. The general public was separated from investment banking, and I think that's what Glass really had in mind.

Senator **Graham**. Those economies which have matured in the last half century—Brazil, some Pacific Rim countries—how have they tended to resolve this issue?

Mr. **Perkins**. I'm not really very familiar with the other ones. I'm more a historian than an expert on current affairs. But Japan I think has come up with a very integrated system. It's one I could cite.

Senator **Graham**. My information was that Japan had adopted the American model as a result of General McArthur's influence after the war. Is that an accurate statement?

Mr. **Kelly**. I think that is an accurate statement, Senator. I think there are signs of relaxation. Of course, the Canadians recently adopted a relaxation. Those are the two economies with which I'm most familiar and I'm afraid I can't comment on the South Americans.

The **Chairman**. Thank you, Senator Graham.

Senator **Graham**. I'll make no adverse comments on your parochialism. It will just be noted in the record for all time. [Laughter.]

The **Chairman**. Senator Hecht.

Senator **Hecht**. No questions.

The **Chairman**. Senator Riegle

Senator RIEGLE. Mr. Chairman, I'm going to give some questions to the witnesses for the record, but I'm sensitive to the time and I want to make sure that we have enough time to hear the other panel.

The CHAIRMAN. Senator Karnes.

Senator KARNES. Thank you, Mr. Chairman. I have a statement that I would like to have submitted for the record.

The CHAIRMAN. Without objection, it will be printed in full in the record.

Senator KARNES. I have no questions. I apologize to the chairman and the committee members and the panelists for arriving late. I did find your testimony very interesting and I appreciate your coming here today and regret that I didn't have the chance to hear the responses. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, gentlemen. You have certainly helped us greatly to have a better understanding of Glass-Steagall. We're going to act on that, I hope fervently, in the next few months and you've given us a very, very good start. Thank you.

Our next witnesses are Henry Kaufman, managing director of Salomon Brothers; Martin Mayer, who is the author of a number of very stimulating books, probably the most prominent and widely read author in the country on money matters and banking; Thomas Johnson, president of the Chemical Bank of New York.

Mr. Kaufman, I understand that you have to leave and therefore we are going to go first with you and if the panel will permit we will question you and then let you go, and then go ahead with the other two witnesses. You are all men of great distinction and I apologize for this arrangement.

Mr. Kaufman, go right ahead, sir.

STATEMENT OF HENRY KAUFMAN, MANAGING DIRECTOR AND MEMBER OF THE EXECUTIVE COMMITTEE, SALOMON BROS. INC.

Mr. KAUFMAN. Well, thank you, Mr. Chairman.

I am pleased to accept your invitation to appear before this committee and I would like to say that the views expressed are my own and not necessarily those of my firm.

I feel very strongly that our financial system is going astray. Many deposit institutions are weak and businesses and households have assumed massive debt burdens. This poses serious risks for our economy. In light of these risks, the current system of financial regulation is inadequate to deal with changes in financial markets. Congress should abandon the current system and pass comprehensive legislation to install a better one.

DESIGNING A BETTER REGULATORY ENVIRONMENT

In designing a better regulatory environment, we must ask ourselves what kind of a financial system do we really want. What should the financial institutions and markets try to achieve? How can this be best accomplished effectively while safeguarding the public trust? Are there important distinguishing aspects between financial institutions and other private enterprises in the economy? In other words, we should begin setting forth a rationale for our financial system and then establish some of the tenets that will move us closer to an improved financial regulatory structure.

To begin, let me say that it would be impossible to run our complex and advanced economy effectively without integrated supportive activity from financial institutions and markets whose role is to intermediate the savings and investment process. Financial institutions and markets reconcile the needs of both the demanders and suppliers of funds. If we did not have an efficient financial system, the behavior of spending units and of savers would be severely limited and our economic performance would be sharply curtailed. Among other things, a well-functioning financial system should facilitate stable economic growth. In a broader sense, it should promote reasonable financial practices and curb excesses.

Some members of the financial community and academic community make an important distinction among the underlying functions of the financial system. They divide the functions into two parts: to provide a mechanism through which flow all payments and to provide the framework through which allocating credit is efficient. This distinction is made because there is a clear need to safeguard the payments mechanism, but it is less clear that our system of credit allocation requires such safeguards. I believe, however, that in the financial world today, these functions are intertwined. The differences between money and credit are blurred. In an attitude that has changed markedly over the past few decades, borrowings are considered by many to be a source of liquidity and therefore a substitute for money or highly liquid assets. Short-term assets like Treasury bills and commercial paper are considered substitutes for money. Thus, the greater risks that may be inherent in today's credit structure are not reduced by paying special attention to safeguarding the payments mechanism, which once upon a time was a cash-only function.

DEVELOPMENTS TO IMPROVE OUR FINANCIAL SYSTEM

Moreover, other important financial changes have taken place that have affected the functioning of our financial system and that have often induced regulatory responses without full thought to the ultimate consequences. I will briefly mention five developments that need to be incorporated in plans to improve our financial system.

First, financial institutions today primarily acquire funds by bidding in the open market. This bidding for funds has been partly responsible for blurring the differences among financial institutions. A broad menu of obligations is available to temporary holders of funds and savers. Many are highly knowledgeable about these instruments and markets. Few institutions hold much in the way of "captive funds" at below market yields.

Second, institutions and other participants in the financial system now actively engage in "spread banking"—and effort through which institutions try to lock in a rate of return that exceeds the cost of their liabilities. This practice began years ago as a commercial banking technique, but other institutions and businesses have followed suit with the creation of many new credit instru-

TABLE [illegible]
The Liquidity of National Banks with Security Affiliates

Variable	Model I	Model II	Model III	Model IV
Intercept	0.0127	0.0141	0.0066	0.0174
	(0.0572)	(0.0587)	(0.0556)	(0.0571)
log Total bank assets	0.0266*	0.0245*	0.0259*	0.0265*
	(0.0095)	(0.0095)	(0.0086)	(0.0090)
Growth of bank deposits	0.0129	0.0074	0.0571	0.0121
	(0.0514)	(0.0538)	(0.0493)	(0.0516)
Affiliate assets/combined assets	0.2252			
	(0.2186)			
Affiliate cash items/noncapital liabilities		0.0005		
		(0.0004)		
Affiliate borrowings/affiliate cash items			0.0002**	
			(0.0001)	
Affiliate noncapital liabilities/bank loans				−0.1412
				(0.0941)
Dummy 1927	0.0268	0.0264	−0.0209	0.0271
	(0.0359)	(0.0363)	(0.0337)	(0.0357)
Dummy 1928	0.0520	0.0294	−0.0465	0.0538
	(0.0336)	(0.0346)	(0.0315)	(0.0335)
Dummy 1929	0.0766*	0.0658**	0.0722*	−0.0808*
	(0.0340)	(0.0345)	(0.0311)	(0.0342)
Dummy 1930	0.0612**	−0.0552**	0.0690*	0.0648**
	(0.0328)	(0.0327)	(0.0301)	(0.0329)
Dummy 1931	0.0863*	0.0776*	0.0747*	0.0881*
	(0.0376)	(0.0376)	(0.0339)	(0.0374)
Dummy 1932	0.0337	0.0227	0.1524	0.0361
	(0.0405)	(0.0395)	(0.0362)	(0.0403)
R	0.4529	0.4279	0.5232	0.4588
F statistic	5.34*	4.57*	6.83*	5.46*
Number of observations	68	65	66	68

Note: The dependent variable was cash items/total deposits. The numbers in parentheses are estimated standard errors.
* Significant at the 0.05 level.
** Significant at the 0.10 level.

CONCLUSION

Commercial banks were attracted to investment banking by the opportunity to diversify their activities beyond those strictly granted to them by law. Banks had a strong incentive to take on a securities business because of economies of scope in the production of financial services. This gave them an advantage over many investment bankers and helped them to win a large share of business in the securities markets by the end of the 1920s. The weak correlation between earnings in commercial and investment banking allowed them to diversify with little additional risk.

The penetration of investment banking followed by the collapse of the stock market made the security affiliates easy targets. The origins of the Great Depression cannot be traced to the operations of commercial banks in securities markets, and much of the criticism of the mixing of commercial and investment banking seems ill founded. Few banks with affiliates failed; and even though Congressional hearings may have uncovered some problems, the securities affiliates did not systematically undermine the capital or liquidity positions of national banks.

The intent of the Glass–Steagall Act was to improve the soundness of banks by separating commercial from investment banking. Restricting banks to certain types of loans, investments, and financial services cannot, however, prevent them from making risky decisions within their limited choices.[16] As banks cannot be prevented from making more risky decisions, the forced separation of different types of financial intermediation fails to accomplish its purported goal and places a burden on the financial industry by separating activities for which there are complementarities in production.

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[16] For some perverse cases where regulation may increase risk taking, see Koehn and Santomero (1980) and Blair and Heggestad (1978).

APPENDIX A: BANKS AND THEIR AFFILIATES

Bank	Affiliate	Location	Years observed
American Exchange National Bank	American Exchange Securities Co.	St. Louis, MO	1929–1932
American National Bank of Beaumont	American National Corporation	Beaumont, TX	1930–1931
Ashland National Bank	Ashland National Co.	Ashland, KY	1926–1928
Brockton National Bank	Brockton National Co.	Brockton, MA	1928–1931
Chase National Bank	Chase Securities Corp.	New York, NY	1926–1932
City National Bank and Trust Co.	City National Co.	Dayton, OH	1929
Commercial National Bank of Shreveport	Commercial National Co.	Shreveport, LA	1926–1930
Fidelity National Bank and Trust Co.	Fidelity National Co.	Kansas City, MO	1928–1929
First Mechanics National Bank	First National Co.	Trenton, NJ	1928–1932
First National Bank of Chicago	First Chicago Corp.	Chicago, IL	1929–1932
First National Bank in Dallas	First National Securities Co.	Dallas, TX	1930
First National Bank in Detroit	First National Co.	Detroit, MI	1928–1929
First National Bank of Mobile	First Securities Co.	Mobile, AL	1928–1932
First National Bank and Trust Co.	First National Rochester Corp.	Rochester, NY	1929–1930
First Wisconsin National Bank	First Wisconsin Co.	Milwaukee, WI	1926–1932
Lincoln National Bank and Trust Co.	Lincoln National Co.	Fort Wayne, IN	1926–1932
National Shawmut Bank of Boston	Shawmut Corp. of Boston	Boston, MA	1926–1927
South Carolina National Bank	South Carolina Securities Co.	Charleston, SC	1927–1931

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ments ranging from floating-rate obligations to interest rate and currency swaps.

Third, these spread banking and related opportunities were greatly enhanced through "securitization"—which, as you well know, is the practice by which a nonmarketable asset is turned into a marketable instrument. Today, many credit instruments have been securitized, including consumer credit obligations, mortgages, high-yield corporate bonds, and many derivative instruments such as options and futures. They have enhanced the growth of the open market and inhibited the growth of the traditional banking market. Yet, many of these instruments, new as they are, are not completely understood and have yet to be tested in both bull and bear markets.

Fourth, financial institutions and markets are much more international in their activities. Funds flow from one country to another electronically with extraordinary speed and in large volume, sometimes moving counter to underlying trade developments. Facilitating these international flows, large U.S. commercial banks and investment banks have built up great operations in key foreign money centers and, concurrently, foreign financial institutions are enjoying an increased presence in the United States. Today, many U.S. borrowers participate in both U.S. and foreign financial markets, and U.S. institutional investors are becoming more familiar with international opportunities. Again, the opportunities for rewards carry risks. Our money center banks' experience in lending to developing countries is one example. Managing the risk of floating exchange rates in a world of 24-hour-a-day trading is another.

Fifth, vast improvements in computer and communications technology are rendering many traditional institutional arrangements obsolete. Technological breakthroughs have a significant impact on the location of physical facilities, the communications linkages with clients, and the magnitude and speed of market decision making.

DEREGULATION OF INTEREST RATES

These changes, to a large extent, reflect the deregulation of interest rates without putting into place concurrently new prudential safeguards. In view of these developments, a number of issues need to be raised and resolved. One is whether financial institutions should be subject to special regulatory treatment. My answer is "yes." This is because financial institutions are entrusted with an extraordinary public responsibility. They have a fiduciary role as the holders of the public's temporary funds and savings. They generally have large liabilities—other people's money—a small capital base and are involved in allocating the proceeds from these liabilities to numerous activities that are critical to the functioning of our economy.

If the role of the financial system carries a public or fiduciary responsibility, as I believe it does, then a governmental role in guiding the system is valid. No highly developed society has treated financial institutions and markets as strictly private activity, and the Congress itself has long since recognized the role of central banking in guiding our financial system.

This distinction also hinges on the necessity for keeping the ownership of a financial enterprise separate from that of business and commercial activity. To combine the two would surely lead to economic and financial concentration, to major conflicts of interest, and to a compromise of the public responsibility of financial institutions. Equally important is that a marriage of business and the financial system would substantially widen the official financial safety net that is now extended only selectively to businesses and institutions when financial difficulties erupt. A mix of commerce and finance would spread the safety net to cover many private large enterprises. This, in turn, could lead to additional economic inefficiencies at the expense of small- and medium-size enterprises that would suffer proportionately more in periods of economic distress. The result would be more economic and financial concentration.

Another question that needs to be addressed is whether financial institutions should experience the benefits and discomforts of monetary policy, or should they be mere conduits that pass the full impact of policy on to households and businesses? In the past two decades, financial institutions have increasingly become conduits. Through spread banking and other techniques, for example, they have quickly passed on the higher cost of funds to local governments, businesses, and household borrowers in order to protect their own profit margins. As a result, much higher interest rates have been required to achieve effective monetary restraint.

The final demanders of credit—such as consumers, businesses and governments—have been encumbered with a higher interest and cost structure. The ability of financial institutions to shift higher costs quickly has encouraged them to become more entrepreneurial and more aggressive as merchandisers of credit. Similarly, the securitization of credit obligations is probably loosening the traditional ties between creditor and debtor, adding to the entrepreneurial drive in the financial system.

The disquieting manifestations of this financial entrepreneurship abound today. Despite a sharp deterioration in the quality of credit reflected on the balance sheets of financial institutions, the drive to exploit growth through the continuing rapid creation of debt is very much alive. Banking institutions that are overloaded with the debt of financially weak developing countries are currently striving to extend credit to sectors in which debtors are still viable, such as households and businesses. The open credit market operates under the false assumption that marketability means high liquidity; it is exploiting the issuance of high-yield bonds and is taking on activities that are akin to bank lending practices.

Let me come to my recommendations, Senator.

RECOMMENDATIONS TO DEAL WITH THE CURRENT PROBLEM

I make the following recommendations to deal with the current problem.

First, it would seem to me in the current situation we need an official control authority to oversee financial institutions and markets. This oversight institution should set minimum standards for capital, uniform reporting standards for financial institutions, and for markets and, require institutions to disclose more fully their assets and liabilities.

Second, because we do have a financial system that is international, there should be a similar international official oversight committee for major institutions and markets. It should, with the cooperation of the major industrial nations, have representatives from these countries and they, in turn, should set uniform capital standards, uniform reporting systems for markets and for financial institutions. Changing capital requirements for major financial institutions should be employed as a technique for implementing monetary policy.

Third, I would strongly recommend that we have a minimum of conflicts of interest and here I would suggest, first, that commerce and finance be kept apart; that, two, there are three distinct functions—underwriting, lending and equity investment—and I believe those three functions should be kept apart and no institution should have the opportunity to be in two or three of these in dealing with business entities.

Finally, I would strongly recommend that we use the Federal deposit insurance as a vehicle for strengthening the financial system and not merely as a device--and I say as a device—for safeguarding depositors. Therefore, I would strongly suggest that we follow a policy that those who have deposit insurance also be required to invest the proceeds from the deposits in high-grade securities or in high-quality loans as determined by the regulator, and those who want to make accommodations to lower-quality bonds, to lower-quality loans, should be asked to make those accommodations with noninsured deposits in another institution.

Thank you, Mr. Chairman.

[The complete prepared statement of Henry Kaufman follows:]

Statement by
Henry Kaufman

My name is Henry Kaufman. I am a managing director and member of the Executive Committee of Salomon Brothers Inc, where I am also in charge of our four research departments. I am pleased to accept your invitation to appear before this Committee, and I would like to say, at the outset, that the views expressed today are my own and not necessarily those of my Firm.

I feel very strongly that our financial system is going astray: Many deposit institutions are weak, and businesses and households have assumed massive debt burdens. This poses serious risks for our economy. In light of these risks, the current system of financial regulation is inadequate to deal with changes in financial markets. Congress should abandon the current system and pass comprehensive legislation to install a better one.

In designing a better regulatory environment, we must ask ourselves what kind of a financial system we really want. What should the financial institutions and markets try to achieve? How can this be accomplished effectively while safeguarding the public trust? Are there important distinguishing aspects between financial institutions and other private enterprises in the economy? In other words, we should begin setting forth a rationale for our financial system and then establish some of the tenets that will move us closer to an improved financial regulatory structure.

To begin, let me say that it would be impossible to run our complex and advanced economy effectively without integrated supportive activity from financial institutions and markets whose role is to intermediate the savings and investment process. Financial institutions and markets reconcile the needs of both the demanders and suppliers of funds. If we did not have an efficient financial system, the behavior of spending units and of savers would be severely limited and our economic performance would be sharply curtailed. Among other things, a

well-functioning financial system should facilitate stable economic growth. In a broader sense, it should promote reasonable financial practices and curb excesses.

Some members of the financial and academic community make an important distinction among the underlying functions of the financial system. They divide the functions into two parts: to provide a mechanism through which flow all payments and to provide the framework through which allocating credit is efficient. This distinction is made because there is a clear need to safeguard the payments mechanism, but it is less clear that our system of credit allocation requires such safeguards. I believe, however, that in the financial world today, these functions are intertwined. The differences between money and credit are blurred. In an attitude that has changed markedly over the past few decades, borrowings are considered by many to be a source of liquidity and therefore a substitute for money or highly liquid assets. Short-term assets like Treasury bills and commercial paper are considered substitutes for money. Thus, the greater risks that may be inherent in today's credit structure are not reduced by paying special attention to safeguarding the payments mechanism, which once upon a time was a cash-only function.

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Second, institutions and other participants in the financial markets now actively engage in "spread banking" -- an effort through which institutions try to lock in a rate of return that exceeds the cost of their liabilities. This practice began years ago as a commercial banking technique, but other institutions and businesses have followed suit with the creation of many new credit instruments ranging from floating-rate obligations to interest rate and currency swaps.

Third, these spread banking and related opportunities were greatly enhanced through "securitization" -- which, as is well-known, is the process by which a nonmarketable asset is turned into a marketable instrument. Today, many credit instruments have been securitized, including consumer credit obligations, mortgages, high-yield corporate bonds, and many derivative instruments, such as options and futures. They have enhanced the growth of the open market and inhibited the growth of the traditional banking market. Yet, many of these instruments, new as they are, are not completely understood and have yet to be tested in both bull and bear markets.

Fourth, financial institutions and markets are much more international in their activities. Funds flow from one country to another electronically with extraordinary speed and in large volume, sometimes moving counter to underlying trade developments. Facilitating these international flows, large U.S. commercial banks and investment banks have built up great operations in key foreign money centers, and concurrently, foreign financial institutions are enjoying an increased presence in the United States. Today, many U.S. borrowers participate in both U.S. and foreign financial markets, and U.S. institutional investors are becoming more familiar with international opportunities. Again, the opportunity for reward has carried risk. Our money center banks' experience in lending to developing countries is one example. Managing the risk of floating exchange rates in a world of 24-hour-a-day trading is another.

Fifth, vast improvements in computer and communications technology are rendering many traditional institutional arrangements obsolete. Technological breakthroughs have a significant impact on the location of physical facilities, the communications linkages with clients, and the magnitude and speed of market decision making.

These changes, to a large extent, reflect the deregulation of interest rates without putting into place concurrently new prudential safeguards. In view of these developments, a number of issues need to be raised and resolved. One is whether financial institutions should be subject to special regulatory treatment. My answer is "yes." This is because financial institutions are entrusted with an extraordinary public responsibility. They have a fiduciary role as the holders of the public's temporary funds and savings. They generally have large liabilities (other people's money), a small capital base and are involved in allocating the proceeds from these liabilities to numerous activities that are critical to the functioning of our economy.

If the role of the financial system carries a public or fiduciary responsibility, as I believe it does, then a governmental role in guiding the system is valid. No highly developed society has treated financial institutions and markets as strictly private activity, and the Congress itself has long since recognized the role of central banking in guiding our financial system.

This distinction also hinges on the necessity for keeping the ownership of a financial enterprise seperate from that of business and commercial activity. To combine the two would surely lead to economic and financial concentration, to major conflicts of interest and to a compromise of the public responsibility of financial institutions. Equally important is that a marriage of business and the financial system would substantially widen the official financial safety net that is now extended only selectively to businesses and institutions when financial difficulties erupt. A mix of commerce and finance would spread the safety net to cover many private large enterprises. This, in turn, could lead to additional economic inefficiencies at the expense of small- and medium-size enterprises that would suffer proportionately more in periods of economic distress. The result would be more economic and financial concentration.

Another question that needs to be addressed is whether financial institutions should experience the benefits and discomforts of monetary policy, or should they be mere conduits that pass the full impact of policy on to households and businesses. In the past two decades, financial institutions have increasingly become conduits. Through spread banking and other techniques, for example, they have quickly passed on the higher cost of funds to local government, business and household borrowers in order to protect their own profit margins. As a result, much higher interest rates have been required to achieve effective monetary restraint.

The final demanders of credit -- such as consumers, businesses and governments -- have been encumbered with a higher interest cost structure. The ability of financial institutions to shift higher costs quickly has encouraged them to become more entrepreneurial and more aggressive as merchandisers of credit. Similarly, the securitization of credit obligations is probably loosening the

traditional ties between creditor and debtor, adding to the entrepreneurial drive in the financial system.

The disquieting manifestations of this financial entrepreneurship abound today. Despite a sharp deterioration in the quality of credit reflected on the balance sheets of financial institutions, the drive to exploit growth through the continuing rapid creation of debt is very much alive. Banking institutions that are overloaded with the debt of financially weak developing countries are currently striving to extend credit to sectors in which debtors are still viable, such as households and businesses. The open credit market operates under the false assumption that marketability means high liquidity; it is exploiting the issuance of high-yield bonds and is taking on activities that are akin to bank lending practices.

Financial market participants, however, will not escape from what has come about. The rapid growth of debt and its costs create a burden on households and businesses that is then, in turn, reflected back on the weaker and more marginal assets of our financial institutions; these institutions then become encumbered with inadequate capital and, consequently, experience pressures to improve profits by moving into other ventures. There is little solace when the deed has been done. By then, the financial system and its participants have been weakened.

In this context, the central bank operates precariously. It has to drive interest rates to hitherto unthinkably high levels when monetary policy restraint is required, because financial institutions have no vested interest in slowing credit availability early; it must also cut interest rates sharply once restraint is effective to avoid bankruptcies. The risk under this approach is that the central bank has to take on the role, increasingly, of lender of last resort to a wider range of financial and business participants. In essence, the recent changes in our financial system have facilitated the transfer of risk to the ultimate borrowers and investors. However, this has not eliminated risks from the system. Indeed, the process has contributed to a faster rate of debt creation, ultimately increasing the risks in the economy.

Financial institutions are not just the guardian of credit, but in a broader sense, they are also the mechanism that can either strengthen or weaken a market-based society. Financial institutions should be part of a process that encourages moderate growth of debt and substantial growth of equity and ownership. To be sure, to achieve such objectives, a correct fiscal and tax structure must be in place. Substantial risk taking and entrepreneurial zeal belongs properly in the world of commerce and trade, where large equity capital tends to reside, and not in financial institutions that are heavily endowed with other people's money. Encouraging increased leveraging of financial institutions automatically induces greater leverage in the private sector, making this area more vulnerable, more marginal and eventually inviting government intervention. The whole process thus undermines the essence of an economic democracy.

In this regard, there are a number of unalterable facts. First, when financial institutions act with excessive entrepreneurial zeal, the immediate outcome is a contribution to economic and financial exhilaration. Only later, when the loan cannot be repaid on time or the investment turns sour, are the debilitating and restrictive aspects of the excesses fully evident. In addition, official exhortation to limit the excesses of financial entrepreneurship are inadequate if not futile.

To some extent, our current regulations encourage risk taking, because large institutions are not allowed to fail, and it is virtually impossible for major financial participants to remain uncompromised to some extent. As is clearly evident all about us today, the competitive pressure to be in the new mainstream of markets is intense. Growth aspirations are difficult to thwart once institutions set targets for profits, market penetration and balance sheet size within a financial framework that prescribes no effective limits and that encourages, with great intensity, the application of financial ingenuity and liberal practices.

Thus, this issue comes down to whether or not financial institutions should be a vehicle for sheltering households and businesses from becoming highly exposed financially. I believe that a bias in this more prudent direction would be quite desirable. In addition to the vulnerabilities that I have already mentioned, a less entrepreneurial financial system would reduce the wide gyrations in the financial markets, encourage longer-term investment decisions and focus society's efforts on meeting economic goals. As I will indicate later, this shift in financial direction is not yet beyond our reach.

Much of the debate on the reregulation versus the deregulation of financial institutions rests on just these issues. Do financial institutions serve an important public role, and in this role, should financial institutions protect households and businesses from financial excesses? The debate should not be decided solely on the basis of the so-called inequities in the marketplace today or on the premise that U.S. financial institutions should have sufficient flexibility to compete with rapidly growing financial institutions and markets in the U.S. and abroad. The resolution of the debate on these particular points will not necessarily strengthen our system. What others do may not be right. Indeed, if our banks had been inhibited in the past from competing so aggressively in the international arena, they would be stronger -- not weaker -- organizations.

However, if the Congress decides that a more deregulated financial system is preferred, at least two challenges will have to be met. How are institutions and markets to be disciplined? And, how will institutions have to be structured to compete on a level playing field? The disciplines of a deregulated financial system are simple in concept, but difficult -- if not impossible -- in reality, to accept, especially in a highly advanced economic society. Efficient institutions will amass profits and prosper, and inefficient ones will stumble and then fail.

The difficulty in accepting such disciplines reflects the fact that the failure of financial institutions involves other people's savings, along with temporary funds from the institutions in question and from other organizations linked to the financial institutions through the intermediation process. Moreover, such a deregulated system will surely burden households and businesses with an even greater overload of debt and make the economy more marginal. I hope that the Congress will not move in this direction.

The obstacles to achieving a level playing field -- a framework that would ensure competitive equality among the different types of institutions -- are formidable. What kind of standards, if any, should institutions be required to adhere to? Can there be true competitive equality if the liabilities of some institutions are Federally insured, while others are not? I doubt that deposit insurance can be eliminated from our financial system. If it were, market participants would assume that the official safety net would cover an even larger portion of the financial system until a major institution is allowed to fail, and then the risks of contraction in the financial system and economy would be extremely high. It is the type of risk that we, as a society, should avoid.

In formulating the groundwork for an improved financial system, we cannot and should not return to the compartmentalized structure that prevailed years ago. Financial life is evolving, and we should be able to retain the best and discard the undesirable aspects of this process of change. To ignore the developments in our financial world will invite the risk of substantial disarray.

Those who favor further substantial deregulation do so on the grounds that such a system, by being highly competitive, will provide services at the lowest cost. They ignore both the special fiduciary role of institutions and the fact that the costs of service delivery are only one aspect in judging the performance of the financial system. They also fail to recognize the consequences of allowing failures to be the sole disciplining force in this system.

Advocates of substantial deregulation, however, do not agree when it comes to deposit insurance. Large institutions often favor the removal of insurance altogether or insurance fees associated with the risks involved in the insured institution. The assumption here is that large institutions will have an advantage, because even in a fully deregulated environment, the Government would be much more hesitant to allow such institutions to fail. The likely consequence would be increased financial concentration. Deposit insurance based on the associated risks would probably also not work well, because higher fees would boost the costs to already-marginal institutions, promote enlarged risk taking to offset these costs and put depositors clearly on notice that they are maintaining accounts with a vulnerable institution where deposit insurance may not hold.

Many advocates of regulation want to maintain the status quo. This position, I believe, is completely unrealistic. Adherents to this view fail to acknowledge some of the important changes that I mentioned earlier: the

The **Chairman**. Thank you very much, Mr. Kaufman.

Mr. Kaufman, can the SEC be the oversight agency for the domestic part of your approach here?

Mr. **Kaufman**. No. I believe that the Securities and Exchange Commission in an interrelated financial market, particularly in the United States and globally, is inadequate to doing this. I think we need an overall oversight committee that may consist of people who have the expertise of the Securities and Exchange Commission, but it should also have members in it that have great knowledge of all of our financial institutions and it should be an integrated effort, not just the Securities and Exchange Commission.

The **Chairman**. You made an excellent statement. We are always very impressed by your testimony. But you spent very little time on the central focus of today's hearings, which is whether or not the separation of commercial and investment banking still makes sense. At the end you made a recommendation in that area, but I'd like to ask you to outline whether the Glass-Steagall Act should be repealed, preserved or modified?

Mr. **Kaufman**. Well, as I tried to indicate, Senator, in my testimony, I believe that we need a new framework for our financial system. The Glass-Steagall Act certainly performed well for a good part of the period in the postwar era and did reasonably well until we had a series of changes.

Now we need a new set of regulations that takes into consideration these changes that I've talked about. I believe that in order to limit the conflict of interest, which was underlying a good part of the Glass-Steagall Act legislation, we should have the separation of business from finance and we should have a clearcut separation when we deal with the financing of business enterprises, that no institution should be all three—lender, investor and underwriter.

There should be a decision made by that institution that it does one and not three. Now that is a different approach that doesn't satisfy I'm sure all my commercial banking friends and I suspect it may not satisfy even all of my friends in the securities industry.

The **Chairman**. Well, it sounds to me like you're sticking with Glass-Steagall.

Now let me ask you one other question. Mr. Johnson will present to us some items and data indicating that the securities industry is heavily concentrated with actual return on equity approaching 40 percent.

You're an economist of great reputation. Is Mr. Johnson correct, and if so, would an increase in the number of participants in the securities industry improve the competitive environment and increase the benefit to consumers?

Mr. **Kaufman**. Well, first of all, the rate of return in the securities industry has fluctuated widely and, as you may know, in the current year the rate of return will be nowhere near 40 percent based on what the first half year has yielded in this industry.

Second, the question really should be, what is best suited for our financial system? One measure of that is, of course, the efficient distribution of the service that we all perform—one measure of that is the lowest possible cost to the public.

There is in the securities industry substantial competition, not only within the industry itself but there is substantial competition coming from Japan as well as from the European markets where there's a large volume of underwriting.

But beyond this, the critical issue shouldn't be banks or securities companies. The critical issue is how best can financial institutions, whether it's investment banks or commercial banks—how best can they serve this country in terms of furthering stable economic growth. I would say the framework that we have today is one in which the financial system contributes to financial instability and ultimately economic instability. And that, I think, is the wrong approach.

It cannot be done on the basis of because we may perform at the lowest cost that this is the best possible way to do it. We should be able to do it where we can promote stable growth, be supportive of the real world, and by a system in which financial institutions are a vehicle that overburdens the business world itself.

The CHAIRMAN. Thank you very much, sir.

Senator Hecht.

Senator HECHT. I would like you to answer the question that our distinguished chairman did not allow you to answer. Is that your position; you're happy with the Glass-Steagall Act? Because you were making different recommendations and he brought up the question.

Mr. KAUFMAN. I think we must recognize financial change. We cannot go back and compartmentalize the financial system the way it existed 20, 30 or 40 years ago. Too much has changed.

Senator HECHT. So you are not in favor of——

Mr. KAUFMAN. I am not in favor of accepting the status quo. In fact, I state that in my testimony, that I am not in favor of the status quo.

I am in favor of a comprehensive revamping of the financial system and in that comprehensive revamping we must have central supervision over the financial system, not supervision over commercial banks, investment banks and someone else doing something for S&L's. The world has changed. We are all bidding for money.

CENTRAL SUPERVISION INTERNATIONALLY

We also ought to have central supervision internationally because the market does not end at the shores of California or at the shores of the east coast.

So I do not want to maintain the status quo or the current Glass-Steagall arrangement.

Senator HECHT. Please explain in greater detail central supervision.

Mr. KAUFMAN. Well, I would have a board of overseers of financial institutions. The function of that board of overseers would be to have an integrated and comprehensive view over the financial system of the United States. It should promulgate capital requirements for financial institutions. It should promulgate reporting standards, disclosure standards. It should control and oversee the supervision of financial institutions and there should be a similar counterpart internationally because of the internationalization of the financial system.

Now perhaps this should consist of in the early stages of some members of the Federal Reserve or all of the Federal Reserve whose powers perhaps should be expanded or it should be a newly constituted group by this Congress.

Senator HECHT. These are awesome powers. Would they be appointed by the President or what do you have in mind? Let's get practical.

Mr. KAUFMAN. All right. I think they should be appointed by the President and those appointments then, of course, have to come before Congress to be acceptable, similar to the appointments that we have for the Federal Reserve Board.

Senator HECHT. I'm just trying to follow your thinking. This board, though, would have awesome powers even greater than the Federal Reserve Board.

Mr. KAUFMAN. Yes, it would in that sense because the Federal Reserve Board only indirectly gets involved with other financial institutions at a time when they are in financial difficulties, when the discount window is opened or the safety net is spread.

But it is illogical to believe that we can have institutions that operate in the American marketplace throughout the country and internationally where we all bid for money one way or the other, whether it is a deposit institution, an investment banker, an insurance company—we all bid for those funds. We do similar types of activities. We are moving closer to similar types of activities but, at the same time, we are regulated in a fragmented way. That creates inefficiency. It creates competition among regulatory authorities in the United States, some of whom are quite good, some of whom are not that good.

Senator HECHT. My first thought is it's going to stifle competition.

Mr. KAUFMAN. No, I think it would not stifle competition. I think it would create a more rational financial system in the United States, a better overview of financial institutions, and perhaps a better functioning system. But I don't think it would necessarily stifle competition.

Senator HECHT. It would be according to the powers you would give to this central authority.

Mr. KAUFMAN. Yes.

Senator HECHT. Well, I don't want to take too much time, but that was a new way to go. That's the reason I wanted to pursue that because of your national reputation. I'm not sure I agree in principle because they always say the Chairman of the Federal Reserve is the second most powerful man in the world. Now he would be relegated to the third position and this man would be in the second position.

Mr. KAUFMAN. Well, as you know, the Chairman of the Federal Reserve Board can be replaced in extreme emergencies. You do have the power to accept or not accept the chairman. You do pass on whoever goes on the Federal Reserve Board itself as such. But I think there can be a number of aspects put into this kind of a board of overseers that can limit the power that requires reporting to Congress and so on.

But I do very strongly believe the current regulatory environment is absolutely different from what is required considering the changes in the financial system.

Senator **Hecht**. Thank you.

The **Chairman**. Thank you, Senator Hecht.

Senator Riegle.

Senator **Riegle**. I think you made some very, very important recommendations to us today that I think require very careful examination and thought.

I have two or three things out of that in the time that we have right now to get into. It seems to me that implicit in what you're saying is that the world has changed so dramatically and that we need to move to this new structure as you've described—implicit in that it seems to me is a statement that we're on a course now that if we don't make these adjustments that we are running big risks to financial stability and soundness. Is that a correct inference to draw?

Mr. **Kaufman**. Yes. We will be running increasing risks in the financial system because the entrepreneurship in the financial system will continue and this is fully understandable. We all are in this market. We all want to compete. We all want to maximize our positions. And with the changes that have occurred, this will mean that when it comes to the creation of credit there will be more than we generally expect. The debt burden will be larger on the private sector than under a more regulated system. The quality of credit will not improve. It's not improving in this period of economic expansion and the next time we get into an economic recession, that fragility in the financial system is going to hurt our capacity to speedily recover and come out of that recession.

Senator **Riegle**. Well, let me ask you this then. If that's the case, and we're in a sense putting more stress on the system now and we're increasing the risks because of the conditions that you described, how far down that track are we at the moment? In other words, I'm wondering what sense of urgency we need to attach to the move to some kind of an adjustment to the system, whether it's the kind you're describing or an alternative kind?

Mr. **Kaufman**. Well, I think the 9 month period or so that you have set before you is a fortuitous period in a sense because I believe the American economic expansion will continue this year and probably perhaps through next year. But if we get into another recession soon, which could be in 1989, I think these problems that are in the system—a weak structure financially, overburdened financial institutions, overleveraged business entities, LDC debt problems—are going to constrict the economic recovery.

So we do have some time here and the period is very appropriate for a change.

Senator **Riegle**. It sounds to me like you're saying that there really is a sense of urgency in your view to try to do this before the next recession comes. In other words, we've got some breathing space here and we'd better use it because when we get tested the next time around in a downturn maybe we will find ourselves too far exposed. Is that a fair way to put the point you're making?

Mr. **Kaufman**. That is correct. I will give you two other reasons why. When we go into that next recession if it should be in 1989, it will be very difficult to utilize fiscal policy very quickly as a stimulative technique because we will get into that period with very large budget deficits. Therefore, we then have to rely on monetary policy. But if by chance that recession will have been brought about because of a weakness in the dollar, the central bank also will not be in a position to quickly respond with monetary accommodation. Therefore, we need a stronger financial network now.

BANK PROFITABILITY

Senator **Riegle**. Now let me ask you this with respect to commercial banks. Do commercial banks need more powers in order to be profitable, in your view? Is there an innate change there that says today that banks just can't be profitable unless they can expand into new lines of activity, in your view?

Mr. **Kaufman**. So far bank profitability has varied considerably and as you know if you remove, for example, the latest reserves, the losses that have been set up, there has been a reasonably good performance in terms of bank profitability.

It is true that the open credit market has competed very heavily for the commercial bank business. That is no secret. Whether it is commercial paper or whether it is the securitization of some loans into marketable obligations. Therefore, this has put the commercial banks under some pressure. There's no doubt about that. And this is why I strongly urge a restructuring of the system, not necessarily along the Glass-Steagall approach, but along the approach that I outlined.

Senator **Riegle**. Well, just related to that, are there any powers that you think banks ought to be given in order to enhance their ability to make a profit or do you think they ought to be able to be sufficiently profitable with the power they have if they use them right?

Mr. **Kaufman**. Well, I believe, Senator Riegle, it goes beyond this. I think any power that you narrowly give to the commercial bank or any other institution in the framework we are in does not resolve the basic issue. And that is, if we don't have Glass-Steagall, what is it that you want to put into place? And I believe you cannot just make a small change. I think there is a need for a significant change.

Senator **Riegle**. A sweeping change?

Mr. **Kaufman**. That's right.

Senator **Riegle**. Thank you.

The **Chairman**. Thank you, Senator Riegle.

Senator Bond.

Senator **Bond**. Thank you very much, Mr. Chairman.

Dr. Kaufman, I've found your arguments very compelling and very interesting. I would say to you that I share a little bit of the confusion that was mentioned earlier by the chairman and by Senator Hecht as to precisely where you're going.

Perhaps you can help me a little bit to understand it. You argue that equity investment, lending and underwriting should all be separated and firms should not be allowed to do two or three of these.

Don't securities firms occasionally do all three?

Mr. **Kaufman**. Yes, we do, and I would say, to the extent that is so, and if the system is changed, we wouldn't be doing all three.

Now I'm indicating here specifically as it applies to business enterprises. I'm not talking about the underwriting of U.S. Government securities, for example, or even State and local securities. I am talking about where the conflict of interest can really endanger the system that we want to live in, and that is a kind of a free enterprise system where there's a significant separation here and a minimum of conflict.

It is true we engage in certain practices in the investment banking business that are perhaps akin to lending at times, and it is true that if you allow commercial banks to underwrite securities of business corporations there would be that conflict there. This is why I specifically state there are three functions when it comes to business corporations and those should be held separate.

Senator **Bond**. I understand that Salomon Brothers recently agreed to participate in a deal to repackage loans made by Marine Midland into certificates for automobile receivables. Is that the kind of transaction that would not be permitted under this approach?

Mr. **Kaufman**. If you reregulated the financial system on this basis, this would remain questionable because I specifically said as it applies to business corporations. Commercial paper issuance for business, making loans to businesses, nonfinancial corporations. Marine Midland here, of course, is a financial institution. This I think would be in the gray area.

I'm not here saying whether Salomon Brothers is right or wrong. We are just doing things in order to make a profit. We are doing things in order to compete, to obtain market share. We are doing things as an investment banking firm to be able to have an area in which many of our young people can work and succeed in. That's part of a system which we're in at the present time.

But with this new approach, I think consumer credit, if it is securitized, is a questionable area whether an investment banker or commercial banker—whether we all should be able to do it. Mortgage securities would be a similar area which would be questionable. But the direct lending and equity financing of a business corporation should be separated.

Senator **Bond**. Well, if I'm not mistaken, one of the contentions many bankers make is that securities firms really have taken much of the business that heretofore was profitable for the banks. By underwriting short-term corporate paper, they took away the market for the commercial banks' loans. By issuing cash management accounts, they look and smell and walk and quack like a checking account. And many people use the services of a securities firm as they would have used the services of a bank.

Now do you think that the securities firms should be permitted to do those things while banks should not be permitted to do them?

Mr. **Kaufman**. No. I believe today money and credit is bought. We buy our liabilities. Commercial banks buy their liabilities to a large extent. There is, therefore, a blurring in that activity.

POTENTIAL CONFLICT OF INTEREST

I believe one of the great concerns is on the asset side of all of our balance sheets. That is where the potential conflict of interest can come in. I am not concerned about checking facilities that any of us may offer, the cash management facilities that any of us may offer. That, to me, is not where the potential conflict of interest lies for the system.

The problems for the system lie in the risk of creating excess credit, credit that is not controlled effectively by a central authority today because of the innovative process, because of the many changes that are in the system. This is where the guardian has to be because right now in our system, the dilemma is basically that we are going to inundate more of the private sector with debt because all financial institutions can now try to arbitrage the difference between the cost of their liabilities and the rate of return on assets. There is no inhibiting force on them in that sense. This is where the overview has to come.

Senator **Bond**. I thank you very much, Dr. Kaufman. I find your arguments very compelling. But I confess that I have not yet seen the light to wind up at the same place that you have, but I thank you for very stimulating testimony.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Bond.

Senator Wirth.

Senator **Wirth**. Thank you, Mr. Chairman.

Dr. Kaufman, thank you again for being with us and you've spent an enormous amount of time down here and we really appreciate your help.

Let me see if I can, first of all, start with what I think are two assumptions that you were making and then raise a point and then a question.

The two assumptions are: First, the special nature of our financial institutions that we don't just go blindly to complete deregulation or the "level playing field" or rush to the bottom. That's assumption number one. I think most of us share that special nature of these institutions.

Second, that change in the regulatory structure is inevitable. Those that call for just the maintenance of Glass-Steagall or just staying where we are are being passed by by the events in the five areas that you outlined along with many others.

Based upon that, you say we have to look for a new regulatory structure and a first principle of that is to assure that we separate banking and commerce, correct?

Mr. **Kaufman**. That is correct.

Senator **Wirth**. Then we go on to say that within the remaining financial institutions which we have separated from commerce, within that, we have to look at a different sort of megaregulatory structure, correct?

Now within what you lay out on page 14 of your testimony is the megaprinciples of how we regulate in this new institution. How do those principles that you lay out on page 14 differ from what has been suggested by Mr. Corrigan of the Federal Reserve in the thoughtful proposal that he brought before the country 6 months ago or so?

PAYMENTS MECHANISM VS. CREDIT MECHANISM

Mr. **Kaufman**. Mr. Corrigan places very heavy emphasis on protecting the payments mechanism. I differ to some extent with Mr. Corrigan because I believe narrowly defined there is a payments mechanism, but in the financial world of today it is very difficult to distinguish the payments mechanism from the credit mechanism. No. 1.

No. 2, it would seem to me that Mr. Corrigan places very heavy emphasis on this because he, as a central banker, wants to be in the position to always be an effective final lender of funds, to be able to prevent systemic risks. He wants to avoid systemic risks.

No. 3, I place heavy emphasis on having a financial system that will not move to the edge of being highly marginal. He does not emphasize that in his proposal. I propose a financial structure that will not be an excessive debt creator. I propose a financial structure that will be reasonable in the extension of debt, that will have certain prudential feelings in it as such.

He places very heavy emphasis that when the system gets in trouble he, as a central banker, he can cope with it. I place more emphasis on having a system that doesn't move to the edge of that marginal position.

Senator **Wirth**. Are you familiar with the Financial Services Act proposed by the commercial bankers? If so, how does your proposal differ from what they are suggesting?

Mr. **Kaufman**. I am not very familiar with the Financial Services Act as proposed by the commercial bankers.

Senator **Wirth**. On a scale of 1 to 10 in terms of differences between the principles that you laid out in the three items that you just identified as distinguishing your proposal from that of Mr. Corrigan, how major are the differences between what you are suggesting and what Mr. Corrigan has suggested?

Mr. **Kaufman**. How major are the differences on a scale of one to ten, ten being an extreme and one being——

Senator **Wirth**. Well, define the scale either way you want. Is there a lot of difference between what you are suggesting and what he is suggesting?

Mr. **Kaufman**. I would say I am halfway there. On a scale of 1 to 10, I would put myself in terms of difference at something like 5.

Senator **Wirth**. And which of the items of the three that you mentioned—payments and credit and central bank and on the edge of risk—which is the biggest one, say, if we were looking at Kaufman and Corrigan side by side, which are the bigger area? I'm trying to put this in some sort of perspective.

Mr. **Kaufman**. My concern is the credit creation process. I emphasize that problem much more than he does and I place much greater value on having a sense of being a fiduciary of the financial system when we have financial institutions. Financial institutions must have a strong feeling of being a fiduciary. I emphasize that more I believe than Mr. Corrigan.

Senator **Wirth**. Thank you very much, Dr. Kaufman.

aggressive bidding for funds by institutions, the globalization and securitization of markets, and the quick pass-through of costs by institutions to final demanders of credit. Only a few have called for some sort of new regulation. For example, Mr. Gerald Corrigan, President of the Federal Reserve Bank of New York, has put forth a well-reasoned and articulate set of proposals for reforming the financial structure. On the whole, he emphasizes arranging the institutions in our system into three groupings: bank and thrift holding companies; financial holding companies; and commercial and financial conglomerates. I believe that this arrangement is influenced by his central banking responsibility. He wants to ensure that the central bank, as the lender of last resort, can function effectively in crisis periods.

Mr. Corrigan's analysis stresses having a well-functioning payments system, and he has argued persuasively for keeping commerce apart from banking. But, as I stated earlier, the blurring of the distinction between money and credit means that safeguarding the payments mechanism is only one part of an improved financial regulatory structure.

What then should be done to establish a reformed financial system that recognizes the changes that have occurred and concurrently provides the underpinnings to encourage stable economic growth and provide for the general well-being of an economic democracy? I suggest the following.

First, an official central authority should be established to oversee all major financial institutions and markets. Today, we live in a highly integrated financial system in which, as I noted earlier, institutions bid for funds and, in some instances, carry on comparable activities in the allocation of these funds. The current system of diverse and overlapping official supervision lacks a coherent overview and fails to meet the realities of the financial world today. This new central authority should also establish minimum capital requirements and uniform reporting standards, and it should require much greater disclosure of the profitability and balance sheet data of our institutions.

When monetary restraint is required, this new centralized authority should increase the minimum capital of financial institutions. In this way, institutions would be restrained, and households and businesses would be less encumbered financially. The reverse would, of course, hold when monetary ease is needed. Capital requirements based on the riskiness of assets is a step in the right direction. This authority should also set a time schedule that would require all institutions to report their asset values at the lower of cost or market. Such a requirement would further inhibit the weakening of our financial institutions.

Second, an official international authority should be established to oversee major financial institutions and markets, regardless of their location. Its membership should consist of representatives from the major industrial nations. As noted earlier, global financial institutions and markets exist today -- a fact that makes the supervision of institutions and markets by national authorities ineffective. Borrowers and institutions quickly arbitrage the regulatory, capital requirements and other differences between one financial center and another. At times, the agility of market participants limits the policy effectiveness of central banks. Consider, for example, how easy it is for participants who have access to international financial markets to circumvent the policy objectives of central banks or how much more forcefully others have to be constrained in order for monetary policy restraint to achieve its objective in tightening markets. Such an official international authority should set minimum capital and reporting standards for all major institutions that operate internationally, and uniform trading practices and standards should be established for participants in open market activities.

Third, because conflicts of interest run the serious risk of undermining the efficient functioning of the financial system and the economy, they must be avoided. There are three activities that need to be kept apart: lending, underwriting of securities, and equity investing. Conflicts of interest are bound to arise if these activities are joined.

With these conflicts of interest in mind, the following principles should underlie new financial regulations.

First, commercial and financial institutions belong apart.

Second, financial institutions should not be allowed to be both lenders and equity investors. The system of regulation should force financial institutions in their dealings with the business sector to choose whether to be an underwriter, a lender or an equity investor.

Finally, deposit insurance should be used to strengthen the financial system -- and not serve only as a guarantee of the safety of deposits. The proceeds from all insured deposits should be required to be invested either in high-grade securities or loans that are deemed to be highly creditworthy by the official regulators. If deposit institutions prefer to make lower-quality loans and investments, they should be booked in another institution and financed with noninsured funds.

There are no easy and quick solutions to the problems that now permeate our financial system. The comprehensive review that the Congress is undertaking currently is a welcome prerequisite for formulating a new and improved structure.

Your investigation should focus not on how quickly the last vestiges of the Glass-Steagall Act can be removed, but rather, the issue before the Congress should be "If not Glass-Steagall, then what?" A fully deregulated financial system is not the solution. Financial institutions have a unique public responsibility. Consequently, a better regulated financial system that incorporates the many changes that have taken place in the past few decades is, in my opinion, the correct way. This will position financial institutions and markets to facilitate economic growth instead of contributing to substantial economic turbulence in the future.

* * * * *

Mr. Chairman, thank you.

The CHAIRMAN. Well, thank you very much.

Mr. Kaufman, I understood that you had to leave at 11:30. It's now 11:27. We have four Senators who are waiting to question you. What's your pleasure? It's up to you. Can you stay?

Senator SANFORD. Mr. Chairman, I certainly would be glad to accommodate his schedule as far as this Senator is concerned. I appreciate the time he's spent.

Mr. KAUFMAN. I regret that I had an appointment scheduled in New York prior to accepting the invitation to appear before this committee and it's an appointment that I just couldn't change, unfortunately.

The CHAIRMAN. All right, sir. Thank you very much. Senator D'Amato, he's your constituent.

Senator D'AMATO. Yes. All three of them are, Mr. Chairman, and certainly I think Dr. Kaufman has brought some very thought provoking ideas to this committee and I agree with Mr. Kaufman that the time of just centralizing this committee's thoughts and actions and the legislative initiatives at breaking down Glass-Steagall is not the answer.

We do need a comprehensive overview as it relates to various activities.

Now reasonable people may disagree as to whether or not it is the board that you, Henry, have suggested, with the vast powers, I have some questions about that, and maybe at another time, whether it be at one of these hearings or privately, I would certainly like to discuss them with you. But I think this is absolutely fallacious to simply to say, well, if Glass-Steagall has to come down and everything is going to be OK, we're going to have the giant megabank that Treasury somehow thinks is going to solve this situation, I think that is just not looking at the kinds of issues that have been raised by members of the committee and that you have responded to, and I think you do us a great service in saying it is more than Glass-Steagall, if we are going to make a positive contribution and bring some stability and also see to it that the proper protection is there as it relates to some investments where the IC is used.

I don't think FDIC insurance should be used in many, many areas that some people would seem to like to take advantage of.

So I certainly thank you for your very thought-provoking testimony.

Mr. KAUFMAN. Thank you, Senator.

The CHAIRMAN. Senator Sasser.

MASSIVE DEBT BURDENS POSE THREATS

Senator SASSER. One quick question. Dr. Kaufman, you indicated in the opening portion of your statement that businesses and households have assumed massive debt burdens, and that this poses serious threats to our economy, and frankly, I agree with you, and I have become very concerned about increasing debt in the economy. And one major factor for this, at least from my point of view, of this greatly increased debt, has been the restructuring craze that has been going on. Corporations are incurring enormous debts, almost $400 billion in the last 2 years, and this is partly a result of corporate takeovers and stock repurchasing to avoid takeovers. At least that is what Alan Greenspan said when he testified here a few days ago.

And Dr. Greenspan, if I am interpreting his remarks correctly, was very worried about that, about the impact of this debt on particular American corporations, on American corporations, generally, on the economy, in general, and on what happens in the next economic turndown, which you said was coming in 1989, with all of this debt sitting out there.

My question is, do you agree with how I have portrayed Dr. Greenspan's views on this whole matter? And your comments would be timely at this point coming at this point, because in a few days, the committee is going to be considering legislation to reform our tender offer laws and move in the direction of some sort of legislation dealing with corporate takeovers.

So I think it would be very worthwhile, Mr. Chairman, if we could just get a comment of what Mr. Kaufman thinks about this whole subject.

Mr. **KAUFMAN**. My answer is, I have been concerned for quite a while about the growth of debt in the United States and elsewhere. Debt is very pleasant when it is created. Debt is very unpleasant when we have to meet it at maturity and the interest payment.

I believe that the creation of debt in the private sector and in some governmental sectors abroad is much too large. This is one of the reasons why I believe we ought to have a financial system that adheres to greater prudential rules of behavior and the sense of the fiduciary. That, I believe, would be one way to slow the growth of debt.

But I would be glad to submit my views in greater detail.

[The following information was subsequently submitted for the record:]

The CHAIRMAN. Thank you very, very much, Mr. Kaufman. We very much appreciate your testimony.

Mr. Mayer, go right ahead, sir.

STATEMENT OF MARTIN MAYER, AUTHOR, SHELTER ISLAND, NY

Mr. MAYER. Thank you. I am delighted to listen to Dr. Kaufman. I will summarize as briefly as I can and leave out as many of the examples as I can, but if I may start by picking up on Senator Sasser's point and Mr. Kaufman's, if you want to do something about the creation of debt, you don't do it by passing that sort of legislation. You do it in the Tax Code, gentlemen.

Right now the U.S. Government subsidizes junk bonds by permitting interest to be paid on debt out of pretax earnings, and it penalizes the issuance of equity by requiring dividends to be paid after post tax earnings. If you are really concerned about the creation of debt, stop promoting it.

Government promotes it. Government promotes it every day, and that is going to be much more effective than writing detailed legislation, associated with tender offers.

LAWS TRY TO CONTROL BEHAVIOR

The first point I wish to make is that laws try to control behavior. Behavior hasn't necessarily changed all that much over 20 or 25, 35, 40 years, 50 years. We saw recently in the Continental-Illinois situation, that the sort of thing that National City Co. did to help National City Bank get out of its bad sugar debt could happen again, even under Glass-Steagall, where we had Continental-Illinois promoting the issuance of notes by Nucorp, which was a busted energy company, in order to bail out its loans. I thought it was particularly suitable that only a few days after that testimony was made under oath in a bankruptcy proceedings, the world put Continental into bankruptcy I thought, most appropriately until the Federal Reserve bullied William Isaac of the Federal Deposit Insurance Corporation into paying off Continental-Illinois' creditors, including the holdings of its Netherlands Antilles paper.

In their recent opinion authorizing bank holding companies to form subsidiaries that will underwrite high-rated municipal revenue bonds, mortgage-backed securities on one-to-four family homes and world-class commercial paper; the new majority of the Federal Reserve Board conceded that "Where the underwriting subsidiary offers securities representing interests in pools of assets created by its affiliates, the temptation exists that the affiliates least creditworthy assets would be securitized."

Nevertheless, the Board, with Paul Volcker dissenting from the vote, argued that "inventives to convert a risky loan held by an affiliate to a security sold to the public by the underwriting subsidiary are minimized by the economic disincentive for a bank holding company to jeopardize the reputation of its underwriting subsidiary as well as of its bank and other lending subsidiaries by engaging in underwritings for this purpose."

But it isn't the bank holding company that makes this sort of decision, it is an executive whose world is about to come about with the revelation of his lousy credit judgment in the XYZ matter. His wife's brother-in-law is on the board of the country club with the president of the underwriting subsidiary, and what the hell, the loan will probably turn out to be all right.

That is the real world, outside the hall of the philosopher kings in Washington.

This is not to say that the Board has been wrong in stretching article 20 of Glass-Steagall or that the courts have let the regulators get away with something. The Banking Act of 1933 is a pretty old piece of law. Where once banks had a virtual monopoly on the kind of information a lender needs, anybody with a screen can now pull up enough data to know whether he is willing to risk money on a commercial paper issue by a "Fortune 500" company. Banks are not needed as intermediaries for such borrowings and brokers with much lower cost structures take away the business.

No harm is done to borrowers, public or the sound operation of the bank, when banks set up departments or holding companies set up subsidiaries to broker commercial paper.

Indeed, so long as the law and the regulators insist that an unaffiliated third party writes the letter of credit supporting the paper, there is sufficient check on illegitimate issuance of commercial paper, even if the bank becomes a dealer rather than just a broker.

Obviously, a dealer must be more heavily capitalized, especially in light of the Goldman, Sachs-Penn Central fiasco of some years ago.

Similarly, the distinction between general obligation paper and high quality municipal bonds should be below the notice of bank regulators, provided again that a third party writes the letter of credit on an arm's length basis and the capital moves from parent to subsidiary only when the grass is greener on the subsidiary side.

I think the banks are right, though the Supreme Court once ruled otherwise, in their contention that if they can offer commingled funds to their trust customers, there is no earthly reason why they shouldn't be able to own and operate mutual funds for sale to the general public.

I see no reason why banks should not own subsidiaries that sell life, home and health, as well as credit life insurance to individual depositors and borrowers, and very little reason to oppose the involvement of banks or bank holding companies in the underwriting of those insurance risks that are actuarially predictable.

New York's experience with saving bank life insurance is entirely positive.

I also support Professor Hyman Minsky's proposal that smaller banks under, say, $500 million in footings, should be permitted to underwrite, distribute and maybe even make a market in securities eligible for short-form SEC registration for small corporate customers.

COLLATERALIZED MORTGAGED SECURITIES

When you get to the operation of big banks in the area of collateralized mortgaged securities, however, the case is far less compelling. It is simply not true, despite the Fed's assertion to the contrary, that CMO's are as safe as the underlying mortgages. What has made mortgages reasonably safe in the last half century is, in part, insurance programs, and in part, the fact that banks have held them first as an investment and then, after the development of the national secondary market, as a possible source of liquidity for additional loans in good times. Now the CMO has become an instrument priced at least in part according to calculations of its duration, calculations which yield constantly changing results. Moreover, synthetic instruments of altered durations can be carved from the single CMO, at which point, its market value becomes extremely volatile.

Now we are in the area of central difference between banks and investment banks. Investment banks, by the rules of the Securities and Exchange Commission, mark their assets to market every night. If Merrill Lynch finds itself $337 million out of pocket on a segment of some of those safe CMO's the Fed wants to authorize banks to deal in and underwrite, Merrill has to tell the world, and very embarrassing it is. But we don't know how badly the collapse of the P/O market hit bank and S&L portfolios, because they can carry all their investment paper at cost and can decide pretty much ad lib what they wish to consider trading inventory and what they wish to consider investment paper.

The threat by the money center banks to abandon their banking charters, if they don't receive security powers, ought not to be taken seriously by anyone, for the fact is, that absent the support of regulatory accounting procedures available only to depositories, they are, almost without exception, technically insolvent.

Regulators permit banks to carry their assets at par, writing them down only when they go so bad, they smell. If the loans are marked "doubtful" by auditors or examiners, loss reserves are taken. But unlike businessmen who are in commerce rather than banking, and are compelled by their accountants to deduct their delinquent accounts receivable from the asset side of the ledger, banks are permitted, by banking regulators, to capitalize their loss reserves on the liability side, while the assets still appear to ride majestically at water level.

These delinquent accounts receivable are part—in some banks today, more than a quarter—of what the regulators trumpet as "primary capital," a category defined to include also the sort of debentures that accountants would make any other business call "debt" by contrast to "equity."

AREAS OF GOVERNMENT INVOLVEMENT

There have been two areas of direct Government involvement in the operation of our banks and thrifts: the Deposit Insurance funds, which Congress, by resolution, if not by law, has declared will, in extremis, have access to the Treasury, and regulatory accounting rules which permit the depositories to present themselves as far more safe and sound than they usually are.

Indirectly, there is the awful precedent of the Continental-Illinois case, where agencies of the U.S. Government said pretty much flat out that they would print as much money as might be necessary to guarantee that the holding companies controlling the largest U.S. banks would never default on any obligation, depository or otherwise.

And in the wider focus, of course, the entire financial industry is deeply infected with questions of public purpose, from the creation of the money supply to the efficiency of the payment system to the allocation of credit.

As an insurer of deposits, the Government must, simply must, retain control over the risks that can be run, which means the assets that can be purchased with those deposits. This is not economics or political science, it is common sense. Control by Federal insurance funds over the assets that can be bought with insured deposits is no more interference with the operation of the free market than is the demand by casualty insurance companies that the wiring be done by licensed electricians. Whatever you do in banking legislation in this Congress, you really must preempt the States out of the asset control area. It is nothing short of appalling that the FSLIC rescue bill passed through its ordeals of fire and water without acquiring en route some such provision to give some little hope that yet another and larger FSLIC rescue bill will not be needed in a year or two.

Flat repeal of Glass-Steagall would compound the imbecility of Garn-St Germain. The one thing that can be said for sure is that those who liked what happened to FSLIC under Garn-St Germain would love what would happen to Federal Deposit Insurance Corporation, not long after the repeal of Glass-Steagall.

The Comptroller believes otherwise, but the Office of the Comptroller of the Currency apparently does not understand insurance. In the letter of November 13, 1986, to the General Accounting Office commenting on GAO's draft report on "Bank Powers," the Senior Deputy Comptroller for Administration argues against "the apparent assumption underlying the report . . . that risk is bad, that is, it results in a realization of losses. The draft does not recognize that the risk of realizing a profit from new activities can be just as great or greater than realizing a loss." But in a situation where the Federal Government charges a one-twelfth of 1 percent premium for full boat insurance of principal and interest on deposits, "just as greater or greater" doesn't do you much good. You need odds of 100 to 1.

What the Comptroller, in fact, endorses is a system where banks get new powers. If they make money, they keep it, and if they lose money, the Government pays.

Those of us who are capitalists rather than civil servants must, on principle, oppose such policies.

I don't want to take up too much time. Let me skip over, since my text will be here.

Certainly, any authorization for banks or bank holding companies to deal in securities with distant maturities or their derivatives, for it is here that the market risks lie, must guarantee that the bank or its corporate parent will not endanger its insured heart to rescue a wounded limb. What the GAO calls market perception separation is essential, and it is by no means certain that it can be accomplished. As Chairman Volcker told this committee on January 21 of this year—

> Common ownership of businesses implies common direction—why else would they want to join together? In particular, the fortunes of one unit rest on the performance of others, especially in an area so sensitive to confidence as banking. All our

experience with the Bank Holding Company Act points to the strong incentives of management to support all parts of the organization when they come under pressure.

And if I may make one more point. The argument is made that we need giant banks to compete with the Japanese, and it is worth a certain degree of risk to the Government to facilitate that competitiveness. But the fact is that Japanese banks are even more constrained than our own in their securities dealings, for their domestic operations are controlled by article 65 of their Securities Act, which we wrote for them during occupation times in imitation of Glass-Steagall, they lack the trust department that give the German and Swiss banks their "placing" or "stuffing" power, and in their foreign activities since 1975, they have, by agreement with the Ministry of Finance exercised only limited securities powers in the Euromarket.

Japanese securities houses now dominate the lists in London, but the only Japanese banks with any significant presence in the Eurobond league tables are two of the long-term credit banks, which are quite different in structure and purpose from our commercial banks, and well down in the second decile, Daiwa Bank, which happens to be the only one of the Japanese banks authorized to perform trust functions.

On my visit to Japan in the spring, the officers of the Federation of Banks there inquired earnestly of my views on how soon the relaxation of Glass-Steagall would come and how great they would be, because it was only through actions here that they could hope to win greater powers for themselves.

We can compete with the Japanese in commodity banking, if we pay attention, and if we also pay attention to the questions of our Government deficit. The reason the Japanese have lower interest rates is that they are a creditor nation. We had low interest rates too when we were a creditor nation.

If we conduct the affairs of this Government in such a way that we become increasingly a debtor nation, then our banks will pay higher interest rates just as the rest of us will. And the dangers from that are the dangers that Mr. Kaufman was listing.

Thank you.

[The complete prepared statement of Mr. Mayer follows:]

DEBT: THE THREAT TO ECONOMIC AND FINANCIAL STABILITY

By Henry Kaufman

It was in the late 1960s when I first detected that developments in debt creation might be taking an ominous turn. Since then I have spoken about the subject a number of times. While many debt problems have surfaced in recent years, the issue of debt and financial stability does not yet have the national attention it so crucially deserves. Now, the problems associated with debt are well past their infancy and, indeed, are dangerously full grown. Even so, there is still only some awareness today that debt has both a sunny and a dark side to it. Historically, the act of creating debt contributed to economic and financial exhilaration. But in the past several years, we have realized that the obligations inherent in debt may impose hardships on lenders and borrowers and, indeed, on the economy and the financial markets as a whole.

The reality is that our debt problem is not going to go away. It is complex; there are no easy solutions. To cope successfully with this problem and to stave off an economic disruption of major proportions, the role of our financial system will need to be redefined, and structural changes and disciplines that are lacking today will have to be imposed. Unfortunately, there is as yet no evidence that adequate measures will be undertaken soon to ameliorate this situation.

The Many Dimensions of the Debt Problem

The debt problem has many dimensions. Most noticeable -- and most talked about -- is the rapid growth of debt. At the end of 1985, total credit market debt -- mainly households, businesses and governments, but also including the financial sector -- totaled $8.2 trillion, compared with $4.6 trillion at the start of the decade and $1.6 trillion in 1970. As shown in Figure 1, total debt rose annually by 7 1/4% in the 1960s, by 11% in the 1970s and has increased by almost 12% at an annual rate thus far in the 1980s.

Figure 1. Growth of Nominal GNP versus Credit (Average Annual Rate of Change)

	1960s	1970s	1980-85	1985	Level[a] (31 Dec 85)
Nominal GNP	6.89%	10.06%	8.07%	5.67%	$3,998.10
Domestic Nonfinancial Debt	6.83	10.40	11.58	15.00	7,131.90
• Corporate	9.40	11.22	10.39	12.40	1,505.10
• Household[b]	8.55	11.40	10.30	12.85	3,224.60
• U.S. Government	1.96	8.83	15.84	16.24	1,660.40
• State and Local Government	7.55	7.39	12.47	34.18	553.10
Foreign Debt in the U.S.	8.57	14.42	5.54	0.61	1,115.60
Financial Debt	14.94	16.78	15.69	21.03	248.90
Total Debt	**7.25%**	**11.06%**	**11.75%**	**15.23%**	**$8,247.50**

[a] Dollars in billions.
[b] Household sector include: farm and nonfarm noncorporate business.
GNP Gross national product.

Debt expansion is also outrunning nominal gross national product (GNP) growth. Credit market debt outstanding at the end of last year exceeded nominal GNP by a ratio of 2:1. In 1980, debt was 70% higher than GNP, and in both 1960 and 1970, it was roughly 50% higher than GNP.

All major sectors of the economy have accelerated their use of credit. Corporate debt, for example, increased by 12.4% in 1985, compared with 9.4% annually in the 1960s. Household debt rose by 12.8% last year, up from an annual average increase of 8.6% in the 1960s. But, the most dramatic step-up by far in borrowings has been incurred by governments: U.S. Government debt rose at an annual rate of 2% in the 1960s, by 9% in the 1970s and has soared by almost 16% annually thus far in the 1980s. Concurrently, state and local government debt expanded by around 7.5% annually in the 1960s and 1970s and has jumped to 12.5% per year thus far in the 1980s. Debt has also burgeoned internationally. At the end of 1985, the medium- and long-term external debt of less developed countries totaled $781 billion, or 159% of their gross merchandise exports, compared with $173 billion, or 73% of their merchandise exports, in 1975.

A significant deterioration in the quality of credit has accompanied this swift debt growth. In the United States, this has been most noticeable in the business sector, where more credit ratings have been downgraded than upgraded since the start of the current business expansion in 1982 (see Figure 2). Today, the universe of AAA-rated industrial and utility corporations has been cut to 26 from 56 a decade ago, when the economy was smaller. Currently, the size of the high-yield bond market (with credit ratings below BBB) is about $100 billion, or roughly 21% of outstanding corporate bonds. In 1976, the size of this market was nearly $19 billion, or 9% of outstandings. At present, only the paper of one large bank-holding company is rated AAA. Ten years ago, this numbered 14.

Figure 2. Changes in Credit Ratings of Nonfinancial Corporate and State and Local Government Bonds, Number and Upgradings (+) Less Downgradings (-)

	All Corporates Including International[a]	State and Local Governments[b]
First Half 1986	-97	+47
First Half 1985	-135	-66
1984	+1	-116
1983	-98	-157
1982	-154	-127
1981	-31	-81
1980	+13	-9
1979	+28	-95
1978	+22	+158

[a] Standard & Poor's.
[b] Moody's.

A glaring contribution to this erosion in quality has been the simultaneous increase in debt and the actual decline in the equity positions of business corporations. Over the two years 1984 and 1985, the debt of nonfinancial corporations rose by $384 billion, while equity contracted by $99 billion. This contraction comprises the total of retained earnings, which were a positive $53 billion, and net new equity issuance which was a negative $152 billion. This disturbing pattern, persisting thus far in 1986, reflects an audacious leveraging strategy that has gone unchallenged by a smaller or larger degree of economic adversity.

Nevertheless, it is beginning to take its toll. The once smoothly functioning corporate bond market is showing signs of weakness. No longer is it the market leader, a role that has been usurped by U.S. Government securities. More importantly, investing in and trading corporate bonds on relative value merits has become increasingly hazardous. "Event risks" such as takeovers have often resulted in a sudden collapse in credit quality, producing large losses for bond investors. Relative value analysis has, as a result, been rendered a less useful tool for bond investing.

This credit quality deterioration is also evident in other sectors. In the state and local government market, overall credit quality growth eroded for the seventh consecutive year in 1985, the latest year for which we have complete data. In the agricultural sector, the value of farmland, after peaking in 1981, has fallen by 25%, while farm debt has continued to mount. As a result, over the past five years, farmers' net worth has fallen by 30%, and many farms are in financial disrepair. Even households do not show the financial strength that they enjoyed a decade ago.

Both the ratios of household debt to disposable personal income and to net worth are at record highs -- they were 25% and 15% lower, respectively, ten years ago. In the current business expansion, the consumer's appetite for credit has been voracious. In the past four years, for example, while disposable income has risen by 32%, households have taken on 42% more in mortgage debt and an extraordinary 73% more in installment debt.

In addition to the ongoing deterioration in these sectors of the economy, there is a relatively new area of weakness -- commercial real estate construction. We are just beginning to realize the extent of this problem. Significant real estate loan losses have been reported at a number of large banking and thrift institutions, not only in the Southwest but nationwide, reflecting the fact that rental income is insufficient to support the debt service of many office projects.

An additional facet of the debt problem concerns the data. Now, all of us who have worked with debt data should readily concede to the shortcomings of these statistics. The Federal Reserve's flow-of-funds data, a prime source for many of us, have many flaws. For example, information on state and local government borrowing is provided with a long lag by the Census Department. The U.S. Treasury, for cost-cutting reasons, has moved to voluntary reporting on many of the capital flows between residents of the United States and foreigners. The data on borrowing and investing abroad by domestic corporations are inadequate in terms of accuracy, completeness and timeliness. The statistics on corporate pension funds and public retirement funds are incomplete and, like many other data, are available only with a considerable delay.

Nevertheless, imperfections in the data do not invalidate the conclusion that the nation faces a very serious debt problem. If anything, the available data probably understate the magnitude of the problem. For example, the Federal Reserve's flow-of-funds data tend to be revised sharply upward from the preliminary report. As shown in Figure 3, two years after the release of the preliminary fourth-quarter 1983 flow-of-funds statistics, the upward revision for nonfinancial debt was nearly 7%. It ranged as high as 40% for some subsectors.

Figure 3. Revisions in Fourth-Quarter 1983 Flow-of-Funds Data (Dollars in Billions)

	Prelim	Revisions					
	4Q 83	2Q 84		4Q 84		4Q 85	
	Amt.	Amt.	Pct. Chg.	Amt.	Pct. Chg.	Amt.	Pct. Chg.
Total Nonfinancial Debt	$509.5	$526.4	3.3%	$526.4	3.3%	$542.9	6.6%
Government	$186.6	$186.6	0.0%	$186.6	0.0%	$186.6	0.0%
Tax Exempt	44.3	56.3	27.1	56.3	27.1	57.3	29.3
Corporate and Foreign Bonds	15.0	15.7	4.7	15.7	4.7	16.0	6.7
Mortgages	168.6	167.3	-0.8	167.3	-0.8	180.3	6.9
Business Loans	19.1	27.3	42.9	27.3	42.9	26.8	40.3
Consumer Credit	54.2	51.3	-5.4	51.3	-5.4	56.7	4.6
Open-Market Paper	-1.2	-1.2	0.0	-1.2	0.0	-1.6	-33.33
Other	23.0	23.1	0.4	23.1	0.4	20.7	-10.0

In addition, we should all understand that the enormity of the debt situation is being masked by accounting conventions and liberal official regulatory standards. Financial statements often tend to show a netting out of assets and liabilities. Given current balance sheet conventions, many business and financial entities probably employ greater leverage of debt to capital than is readily discernible.

The Underlying Causes of Debt Growth

How did this enormous growth of debt come about and what is sustaining it? Merely to blame the incorrect policies that fueled inflation is too easy; there is much more to the debt explosion. I have written at length about the underlying causes of the surge in debt. For this discussion, let me summarize with the following seven points: The attitude toward debt, financial deregulation, financial innovation, securitization, financial internationalization, the tax structure, and practicing debt prudence.

- **The attitude toward debt** has been a transformation from a hesitancy to borrow in the early past World War II years to an intense use of credit in recent years. This attitudinal change reflects the declining influence of those who experienced the Great Depression of the 1930s. Indeed, despite a series of greater or less financial crises during the past 20 years, only relatively few institutions failed. Today, no one celebrates paying off the home mortgage. Now.corporate financing strategies do not differentiate between money and credit or between liabilities and liquidity.

- **Financial deregulation**, regardless of its merits, still facilitates the creation of debt, because it spurs competition, and reinforces the drive for new markets and enlarged market standing. Credit growth was more inhibited when markets were more compartmentalized and institutions were more restricted in their activities.

- **Financial innovation**, by its very nature, either facilitates a credit that could not have been financed at all using earlier techniques or is utilized to reduce financing costs. Perhaps the most far-reaching of the many changes that have been introduced in the past few decades has been floating-rate financing. This technique enables financial institutions to try to insulate themselves from the interest rate risk by quickly passing on increases in the cost of their sources of funds to their borrowers. In the past, a move toward higher interest rates curbed debt growth because financial institutions could not easily pass on the higher costs to their customers. But with the advent of the pass-through device of the floating-rate note, financial institutions have become aggressively more entrepreneurial and growth oriented than in the past.

- **Securitization**, which transforms obligations from nonmarketable to marketable, has encouraged debt growth in several ways. First, it tends to create the illusion that credit risk can be reduced if the credit instruments become marketable. Holders of the marketable obligation frequently believe that they have the foresight to sell before the decrease in creditworthiness is perceived by the market. Second, the enhancement techniques employed in securitization, such as credit guarantees and insurance, blur the credit risk and raise the vexing question, "Who is the real guardian of credit?"

- **Internationalization of finance** has also enhanced debt creation. Today, major corporations and official and private institutions seek the best terms by borrowing in Europe, the United States and Japan. Rapid advances in communications and technology, together with financial deregulation abroad, have intensified competition among key financial centers. In view of the differences in the degrees of deregulation, regulatory requirements and accounting standards, the opportunity to generate debt is very great indeed.

- **Our tax structure** is another factor that encourages the use of debt over equity. Interest payments are generally tax deductible. Although this preferential treatment may be curtailed somewhat by the proposed tax reform, dividend payments are still subject to double taxation, and the levy on capital gains may be raised.

- **Practicing financial prudence** is virtually impossible for major participants in our financial system. Even the best compromise. For business corporations, this may happen through the use of greater leveraging in order to avoid a takeover. As I have noted in my book,[1] "If (financial) participants fail to adapt to the new world of securitized debt, proxy debt instruments, and floating-rate financing, then they lose market share, make only limited profits and do not attract the most skilled people. The driving force behind profit generation is credit growth."

The Risks and Policy Challenges of Financial Stability

What risks do the mounting debt pose for financial stability? Here no simple formula will reveal to us the flashpoints of economic and financial trouble. The fact is that the debt buildup in the past two decades has been greater than most would have thought tolerable. Several credit crises have been surmounted, and both the economy and financial markets have survived. Interest rates rose to levels that were unimaginable in earlier years. But, while the financial system remained intact, its structure and financial practices were altered dramatically. Nevertheless, it cannot be denied that our system is now more marginal and more highly leveraged than at any time in the past 40 years. This might be less disturbing if business cycle volatility had been curtailed, but this has not been the case. Another matter of concern is that debt can severely restrict freedom of action when income slows and debt servicing needs preempt much of the income that is left. In contrast, of course, large equity positions relative to debt provide society with enhanced freedom and with maximum economic flexibility. Given these observations, huge debt will add a very troubling dimension to the next business recession. If a major economic and financial upheaval is to be avoided, official policymakers must act with alacrity. There will be less leeway for errors in policy decisions and implementation.

The greatest need is to harness effectively the growth of debt. How can this be accomplished in our new financial world of deregulation, securitization, globalization, and innovation? We cannot and should not attempt to return to the financial markets of yesteryear. Too much has changed. We need a framework that will get the best out of the current financial system and ward off the worst.

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[1] Henry Kaufman, Interest Rates, The Markets, and the New Financial World, (New York: Times Books, 1986).

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Testimony to Senate Banking Committee

My name is Martin Mayer, and I write about various subjects, mostly, in recent years, finance. I have been writing about financial markets for 35 years. My first book in this area was Wall Street: Men and Money, published in 1955; the others include New Breed on Wall Street in 1969, The Bankers, for which the chairman was kind enough to give a selling quote, in 1975; The Builders (a book about housing with several chapters on housing finance) in 1978; The Fate of the Dollar in 1980; and The Money Bazaars in 1984. I am now at work on a book about markets. During the last few months, my reports or comments on these subjects have appeared in The Wall Street Journal, The New York Times, The Los Angeles Times, Business Month, Financier, and The American Banker, for which I write a twice-a-month column. I also lecture extensively to groups in the financial services industry. In the 1960s, I was involved with the government for several years as a member of the President's Panel on Educational Research and Development in the Kennedy and Johnson White House, and in 1981-1982 I was a Commissioner of President Reagan's National Commission on Housing. My interest in revisions of the Glass-Steagall Act

is entirely that of a citizen: I am not on the payroll of any financial institution, and own no stock in any corporation. I am here because I think the banking is an important subject, and I am pleased that the Committee wishes to hear what I have to say about it.

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In 1927, the National Bank Examiners questioned the viability of some loans on Cuban sugar properties that were being carried at par by National City Bank of New York. The securities affiliate of the bank, National City Company, thereupon went out and sold a bond issue (most of it to people who borrowed the bulk of the cost of the bonds from National City Bank) and used the proceeds, without telling anybody about it, to buy up at par the loans the examiners wanted the bank to write down.

Couldn't happen now, you say, quite apart from Glass-Steagall. Well, in 1984, Continental-Illinois found itself with a busted loan to an energy company called Nucorp. According to depositions under oath, the bank suggested to Nucorp that the company sell notes to the public and pay off the loans to C-I. Nucorp did so, employing the services of Continental as trustee for the notes. Ninety-one days after its own loans had been repaid (thus absolving the bank from any legal liability to disgorge as a preferred creditor), Continental as trustee put Nucorp into bankruptcy. A couple of days after this story surfaced in the bankruptcy proceeding, the world put Continental into the banking business's equivalent of bankruptcy, I thought most appropriately, until the Federal Reserve bullied William Isaac of the FDIC into paying off all of C-I's creditors, including the holders of its Netherlands Antilles paper.

The people who now say no modern bank would engage in such shenanigans are the same people who used to describe C-I as the Morgan of the midwest. One notes for what it's worth, which is probably neither a lot nor nothing, that one of the jurors in the FDIC's recent suit to recover from Ernst & Whinney some of the agency's C-I losses told a reporter from American Banker that the jury had refused to blame the auditor because of its members' feelings that Continental-Illinois had been so corrupt that you couldn't expect an outside accountant to be able to find out what was really going on.

Comptroller of the Currency Robert Clarke says that banks have an undoubted power to sell off any of their assets to anyone at any time they wish and in any way they wish. Including, presumably, companies they create for the purpose of buying those assets and unloading them on third parties. All these loans, after all, are worth their face value or better, so far as the Comptroller knows, because banks unlike non-banks in the financial intermediation business are allowed to carry their assets at par and need

not mark their investment paper or their mortgages or their loans to market.

In their recent opinion authorizing bank holding companies to form subsidiaries that will underwrite high-rated municipal revenue bonds, mortgage-backed securities on 1-4 family houses and world-class commercial paper, the new majority of the Federal Reserve Board conceded that "Congressional concern over bank securities affiliates' underwriting and making markets in the securities issued by their bank affiliates was cited [by the Supreme Court] as one of the principal reasons for the Glass-Steagall Act," and also that "where the underwriting subsidiary offers securities representing interests in pools of assets created by its affiliates, the temptation exists that the affiliates' least creditworthy assets would be securitized." Nevertheless, the Board (Paul Volcker dissenting from the result) argued that "incentives to convert a risky loan held by an affiliate to a security sold to the public by the underwriting subsidiary are mimimized. . .by the economic disincentive for a bank holding company to jeopardize the reputation of its underwriting subsidiary as well as of its bank and other lending subsidiaries by engaging in underwriting for this purpose."

But it isn't the bank holding company that makes this sort of decision--it's an executive whose world is about to come apart with the revelation of his lousy credit judgment in the XYZ matter. His wife's brother-in-law's uncle is on the board of the country club with the president of the underwriting subsidiary, and, what the hell, the loan will probably turn out all right. . .That's the real world, outside the hall of the philosopher kings in Washington.

This is not to say that the Board has been wrong in stretching Article 20 of Glass-Steagall or that the courts have let the regulators get away with something. The Banking Act of 1933 is, after all, a pretty old piece of law, and the world has changed since. Where once banks had a virtual monopoly on the kind of information a lender needs, anybody with a screen can pull up enough data now to know whether he's willing to risk money on a commercial paper issue by a Fortune 500 company. Banks are not needed as intermediaries for such borrowings, and brokers with much lower cost structures take away the business.

No harm is done to borrowers, public, or the sound operation of the bank when banks set up departments or holding companies set up subsidiaries to broker commercial paper. Indeed, so long as the law and the regulators insist that an unaffiliated third party writes the letter of credit supporting the paper, there is sufficient check on illegitimate issuance of commercial paper even if the bank becomes a dealer rather than just a broker. Obviously, a dealer must be more heavily capitalized, especially in light of the Goldman Sachs/Penn Central fiasco, in which Goldman

eventually put up well over $50 million to make whole the purchasers of Penn Central paper peddled by the investment bank after its internal group had decided not to hold such garbage in Goldman's own accounts. And there must be only a narrow gate through which capital can flow from the parent holding company to its securities affiliate. But the thing can be done.

Similarly, the distinction between general obligation paper and high-quality municipal revenue bonds should be below the notice of bank regulators--provided again that a third party writes the letter of credit on an arm's length basis and that capital moves from parent to subsidiary only when the grass is greener on the subsidiary's side. And I think the banks are right, though the Supreme Court once ruled otherwise, in their contention that if they can offer commingled funds to their trust customers there's no reason why they shouldn't be able to own and operate mutual funds for sale to the general public.

To continue a personal litany of desirable changes in the law, I see no reason why banks should not own subsidiaries that sell life, home and health as well as credit life insurance to individual depositors and borrowers, and very little reason to oppose the involvement of banks or bank holding companies in the underwriting of insurance risks that are actuarially predictable. New York's experience with Savings Bank Life Insurance is entirely positive. I also support Professor Hyman Minsky's proposal that smaller banks, under, say, $500 million in footings, should be permitted to underwrite, distribute and maybe even make a market in securities eligible for short-form SEC registration, for small corporate customers.

When you get to the operations of big banks and the area of collateralized mortgage securities, however, the case is far less compelling. It is simply not true, despite the Fed's assertions to the contrary, that CMOs are as safe as the underlying mortgages. What has made mortgages reasonably safe in the last half-century is in part insurance programs and in part the fact that banks have held them first as an investment, and then, after the development of the national secondary market, as a possible source of liquidity for additional loans in good times (not, if you were prudent, in bad times, when everyone will try to pile into the lifeboat). Now the CMO has become an instrument priced at least in part according to calculations of its duration (i.e., how fast people are likely to pay back their mortgages), calculations which yield constantly changing results. Moreover, synthetic instruments of altered durations can be carved from the single CMO, at which point its market value becomes extremely volatile.

And now we are in the area of central difference between banks and investment banks. Investment banks, by the rules of the Securities and Exchange Commission, mark their assets to market every night. If Merrill Lynch finds itself $275 million out of pocket on a segment of some of those safe CMOs the Fed wants to authorize banks to deal in and underwrite, Merrill has to tell the world, and very embarrassing it is. But we don't know how badly the collapse of the P/O market hit bank and S&L portfolios, because they can carry all their investment paper at cost, and can decide pretty much ad lib what they wish to consider trading inventory and what they wish to consider investment paper. The New York State Banking Department, once rather active but now immobile in the middle of the boat it knows it must not rock, bullied into a catatonic state by Morgan and Manny Hanny and Chemical, has noted regretfully that some of the savings banks in its charge--unnamed (mustn't shake confidence)--have endangered their continuance through unpublicized losses on such paper.

The threat by the money-center banks to abandon their banking charters if they don't receive securities powers ought not to be taken seriously by anyone, for the fact is that absent the support of regulatory accounting procedures available only to depositories they are almost without exception technically insolvent. Regulators permit banks to carry their assets at par, writing them down only when they go so bad they smell. If the loans are marked doubtful by auditors or examiners, loss reserves are taken--but unlike businessmen who are in commerce rather than banking and are compelled by their accountants to deduct their delinquent accounts receivable from the asset side of the ledger, banks are permitted by banking regulators to capitalize their loss reserves on the liabilities side, while the assets still appear to ride majestically at water level. These delinquent accounts receivable are part (in some banks today, more than a quarter) of what the regulators trumpet as "primary capital," a category also defined to include the sort of debentures that accountants would make any other business call "debt" by contrast to "equity."

We have, then, two areas of direct government involvement in the operation of our banks and thrifts: the deposit insurance funds, which Congress by resolution if not by law has declared will in extremis have access to the Treasury, and regulatory accounting rules, which permit depositories to present themselves as far more safe and sound than they usually are. Indirectly, there is the awful precedent of the Continental-Illinois case, where agencies of the U.S. government said pretty much flat out that they would print as much money as might be necessary to guarantee that the holding companies controlling the largest U.S. banks would never default on any obligation, depository or otherwise. And in the wider focus, of course, the entire financial industry is deeply infected with questions of public purpose, from the creation of the money supply to the

efficiency of the payments system to the allocation of credit.

As insurer of deposits, the government must--simply must--retain control over the risks that can be run, which means the assets that can be purchased, with those deposits. That's not economics or political science, it's common sense. Control by federal insurance funds over the assets that can be bought with insured deposits is no more interference with the operation of the free market than is the demand by casualty insurance companies that the wiring be done by licensed electricians. Whatever you do in banking legislation in this Congress, you really must pre-empt the states out of the asset control area; it's nothing short of appalling that the FSLIC rescue bill passed through its ordeals of fire and water without acquiring en route some such provision to give some little hope that another and larger FSLIC rescue bill will not be needed in a year or two. Even Richard Pratt, an absolute free-market man speaking ex cathedra from Merrill Lynch, has admitted that current law is defective in the power it gives the states to put their hands into the federal Treasury by approving all sorts of high-risk activities by the S&Ls and banks they charter and Washington then insures. Obviously, any extension of bank or bank holding company powers in the securities area must be calculated to minimize the chance that losses from such activities will not trigger losses to the deposit insurance funds. Flat repeal of Glass-Steagall would compound the imbecility of Garn-St Germain. The one thing that can be said for sure is that those who like what happened to FSLIC under Garn-St Germain would love what would happen to FDIC not long after the repeal of Glass-Steagall.

The Comptroller believes otherwise, but the Office of the Comptroller of the Currency apparently does not understand insurance. In the letter of November 13th 1986 to the General Accounting Office commenting on GAO's draft report on "Bank Powers," the Senior Deputy Comptroller for Administration argues snottily against "The apparent assumption underlying the report. . .that risk is bad, that is, it results in a realization of losses. The draft does not recognize that the risk of realizing a profit from new activities can be just as great or greater than realizing a loss." But in a situation where the federal government charges a one-twelfth of one per cent premium for full boat insurance of principal and interest on deposits, "just as great or greater" doesn't do you much good. You need odds of hundreds to one. What the Comptroller in fact endorses is a system where banks get new powers, if they make money they keep it and if they lose money the government pays. Those of us who are capitalists rather than civil servants must on principle oppose such positions.

Moreover, if I may digress for a paragraph, I suspect that some degree of control over the interest that can be paid on insured deposits is also essential, though obviously it should come in the form of reference to a benchmark market rate of interest external to the depository system rather than as an absolute ceiling. Clearly, if the Treasury pays 7% APR for one-year notes, a more convenient bank deposit eventually insured by the Treasury should not have to pay much more than 8%, if that, and anyone who does pay more than that should be suspected of risking what is in the last analysis the Treasury's money in impermissible ways. In passing, let me note that risk-adjusted premiums are for the birds, because a man who is prepared to pay an additional 250 basis points for accounts will not be frightened by an additional 8 basis points on his insurance premium. There might be some value in risk-based premiums if you would pass a law obliging a money-broker to inquire as to the risk rating of an institution to which he sends his client's money and making him a co-insurer when that institution has been assessed a high premium, but nobody seems to be asking for that.

Beyond the insurance of deposits, of course, is the spectre of Continental-Illinois' billion dollars of Netherlands Antilles commercial paper, sold to people who had a choice of whether or not to pay taxes on the interest, here or elsewhere. These people were paid off by FDIC.

adding about a billion dollars to the federal deficit for 1984. As a result, FDIC's enthusiasm for giving banks securities powers has been somewhat tempered, and its comments on the GAO study are essentially supportive. In authorizing securities powers for insured non-member state banks in states permitting such activities, FDIC has at least in principle (the dates for applying the rules keep getting pushed back) insisted that the securities subsidiaries have separate officers and offices, in different buildings or at least through different entrances, and a name that not only reads different but--in terms of letterhead and advertising style--looks different from that of the bank.

Certainly, any authorization for banks or bank holding companies to deal in securities with distant maturities or their derivatives (for it is here that the market risks lie) must guarantee that the bank or its corporate parent will not endanger its insured heart to rescue a wounded limb. What the GAO calls market perception separation is essential, and it is by no means certain that it can be accomplished. As Chairman Volcker told this committee on January 21st of this year, "Common ownership of businesses implies common direction--why else would they want to join together? In particular, the fortunes of one unit rest on the performance of others, especially in an area so sensitive to confidence as banking. All our experience with the Bank Holding company Act points to the strong incentives of management to support all parts of the organization when they come under pressure."

The argument is made that we need giant banks to compete with the Japanese, and that it's worth a certain degree of risk to the government to facilitate that competitiveness. But the fact is that Japanese banks are even more constrained than our own in their securities dealings, for their domestic operations are controlled by Article 65 of their Securities Act (which we wrote for them during occupation times in imitation of Glass-Steagall), they lack the trust departments that give the German and Swiss banks their "placing" (or "stuffing") power, and in their foreign activities since 1975 they have by agreement with the Ministry of Finance exercised only limited securities powers in the Euromarkets. Japanese securities houses now dominate the lists in London, but the only Japanese banks with any significant presence in the Eurobond league tables are two of the long-term credit banks, which are quite different in structure and purpose from our commercial banks, and, well down in the second decile, Daiwa Bank, which happens to be the only one of the Japanese banks authorized to perform trust functions. On my visit to Japan in the spring, the officers of the Federation of Banks there inquired earnestly of my views on how soon the relaxations of Glass-Steagall would come and how great they

The CHAIRMAN. Thank you very much, Mr. Mayer.

Mr. Johnson.

STATEMENT OF THOMAS S. JOHNSON, PRESIDENT, CHEMICAL BANK

Mr. JOHNSON. Thank you, Mr. Chairman.

I am very pleased to be here today to participate in this important discussion. I am sure that everyone in this room is familiar with the powerful forces that are sweeping the financial services industry. We know them as "globalization," "securitization" and "technology." And they are causing irreversible change in the financial services needed and demanded by individual and corporate clients.

Given these trends, a rational regulatory framework would accommodate change—would allow for innovations and encourage the system to evolve safely toward a healthier, more efficient condition.

In my view, this means a regulatory framework that enhances both the soundness and the competitive position of the U.S. banking system and enables it to serve the consumers of financial services.

Tragically, however, our regulatory framework today does not do this: it is a maze of inconsistencies and bizarrely out of date.

On the subject of today's discussion, it is a sad irony that the Glass-Steagall Act, which was passed to promote the safety and soundness of the banking system, is today having exactly the opposite effect.

By preventing commercial banks from adapting to competitive challenges and customer needs, Glass-Steagall actually weakens their posture and renders them more susceptible to problems.

EARLY WARNING SIGNALS

You can already see the early warning signals. The number of troubled banks is rising. Banks' loans represent a steadily declining share of the Nation's short-term commercial credit, down from 75 percent just 5 years ago to 50 percent today. Return on assets at the money center banks has been in steady decline over the past 15 years.

These are warnings, that the laws and regulations governing the banking system need some attention. By "attention," let me emphasize, I do not mean favors. Banks do not want or need a bailout, a subsidy or protection. What they need is the opportunity to compete in the financial services marketplace on the same basis as other firms in reflecting today's world.

In my view, it comes down to this: if we want a healthy financial system, and if we expect our Nation's banks to provide consumers with the best financial services, then we must maintain justifiable regulatory oversight and permit banks to modernize their delivery of financial services. If we don't, the consequences are likely to be a further weakening of the banking system.

Commercial banks based in the United States are being tested by global competition, just as our auto makers, steel factories and other manufacturers are. They are being tested by large foreign-based concentrations of financial fire power, such as that represented by Sumitomo Bank's $500 million investment in Goldman, Sachs.

If, instead of acting wisely, we continue fighting intramural battles over our domestic financial system, then Japanese, German, Swiss and British institutions will elbow our banks out of the marketplace altogether.

Since 1973, foreign banks have almost tripled their share of the U.S. commercial loan business—to 22 percent.

As of this year, only two of the largest 25 banks in the world are American, in terms of market capitalization.

J.P. Morgan, the U.S. bank with the largest market capitalization, stands No. 19 on that list, with a valuation of less than $8 billion.

By contrast, Sumitomo Bank, the Japanese bank with the largest market cap, stands first, at $58 billion.

The same contrast, incidentally, would hold within the securities business, where Namura is capitalized in the marketplace at something like $60 billion and the largest American securities firm, which would be probably American Express, although it includes a lot beyond securities, is capitalized at only $12 billion.

That extra size gives Sumitomo and other large foreign banks an advantage over our banks in engineering the multibillion dollar deals so vital to worldwide business today. As president of a large U.S. bank, I know that our Nation's banking system has the technology and the talent to compete with anyone anywhere. In fact, a number of the most important innovations that are transforming global financial markets, swaps, for example, were developed by U.S. banks. We have the capacity to flourish as an industry, our Nation's cities, New York, Chicago, Los Angeles, Miami, Houston and others, can be global financial centers, but only if our laws don't limit their ability to compete.

Another challenge is the change in the nature of the financial services needed and demanded by the American banking consumer. Whether that consumer is a town mayor, who wants the lowest cost of funding for a local project, a corporate treasurer, who wants the cheapest source of operating funds or the individual saver, who wants to invest his or her savings in a diversified investment pool, the American consumer of financial services is demanding more than the local bank is allowed to provide.

ENORMOUS PRESSURE ON COMMERCIAL BANKS

This creates enormous pressure on commercial bankers and a great deal of frustration, I might add, as we try to serve the needs of our customers.

After all, commercial bankers are still confined to the same basic savings products as in 1933. In the meantime, we have been challenged by mutual funds, savings and loans, insurance companies and other entities that offer innovative products that commercial banks aren't allowed to compete with.

A customer can come into one of our branches and invest his or her savings in a municipal bond. But if that customer wants to diversify his risk and invest in a fund of municipal bonds, Glass-Steagall keeps us from creating and offering what he or she wants.

Small business customers are similarly hampered from getting competitive services.

They traditionally come to a bank for their financial needs; we know their businesses. We lend them money for growth. We manage their cash and provide other services. Yet when these companies become large enough to tap the corporate bond and commercial paper markets, they enter a realm forbidden to commercial banks and dominated by a cartel of securities firms.

Because of an antiquated law, we are not allowed to grow with them, to continue to serve our customers in meeting their expanding needs.

The rules are silly. U.S. banks can lend an American company short-term funds. But our right to facilitate a commercial paper issue for the same purposes is being fought tooth and nail by the handful of firms that have dominated that market. We can lend money to a General Motors or another good American corporation here in the United States. We can underwrite and distribute bonds for them abroad, but we can't serve our own U.S. customers that way in our own home market.

That is neither logical nor efficient, especially in a globalized financial market, and it certainly doesn't help American companies get the best interest rates and overall service.

Nor American municipalities, by the way. In recent months, underwriting fees for revenue bonds, where commercial banks are basically not allowed to compete, have been between $1 and $2 and even as much as $5 per $1,000 of par value above the fees for comparable issue of general obligation bonds where banks do compete.

In all of these instances, our clients are at the mercy of a handful of securities firms, while we are blocked from adding our competitive muscle to the marketplace. Because of a law that is, at best, outdated, the client loses.

Now I can fully understand the motivation of firms that employ considerable resources down here to maintain the status quo. Obviously, it is in their self-interest to resist any inroads into their protected business and to suggest dire consequences if banks are permitted onto their protected turf.

Five securities firms already control 90 percent of the commercial paper business.

Ten securities firms already have 90 percent of the $200 billion corporate security underwriting business.

They also control over 60 percent of the total capital of their industry.

Ten investment banks take nearly half the total pretax profits of the entire securities business in the United States.

Their professionals urge staggeringly high rates of compensation, and when compensation is included in operating earnings, the firms enjoy returns on equity in the 40-percent range, a clear indication of just how a securities cartel costs the American consumer.

You can see, therefore, why Wall Street is so fervently behind Glass-Steagall, but in the interests of consumers, it is obvious that banks should be allowed to join other financial firms in competing head to head across the full spectrum of financial services.

NEW POWERS

"New powers" is not the issue. The issue for the Nation is how to have a financial system that reflects today's technology, today's consumer needs and today's international competitive challenge.

For commercial banks, the issue is permission to engage in new forms of delivering the services they have always delivered. There is nothing new about the municipal bond business, but revenue bonds are still over 50 percent of the market and on a technicality, we are blocked from competing.

There is nothing new about short-term commercial funding, but commercial paper is today the most efficient way to get funds to large firms.

There is nothing new about Americans going to their local bank to invest their savings, but mutual funds represent an increasingly attractive way to invest these savings.

The fact is, there is a new reality out there in the marketplace—the reality of technical change and international competition. You know it and I know it, and it is dangerous for us to avoid it.

We only harm consumers and the economy by retaining laws passed over 50 years ago in an era when bond prices hardly moved, when there were no swaps, no NIFS, no RUFS, almost no revenue bonds, no mortgage-backed securities, no Eurodollar market at all or any of the other revolutionary innovations of our day.

Instead of being continuously and piously reminded that we must stay put and operate under these old rules, American banks need the freedom to contend with the powerful forces that are transforming our industry. We need a new public policy that would need a healthier, more diversified stream of earnings for the banking system, based in the United States, not overseas, able to compete internationally.

For these reasons, we welcome the process that you have set in place, Mr. Chairman, and we hope to work with you very closely over the months ahead, in order to resolve these issues.

[The complete prepared statement of Mr. Johnson follows:]

would be, because it was only through actions here that they could hope to win greater powers for themselves.

A more sophisticated argument offered by our more sophisticated bankers works from that premise to claim that we must deregulate here to encourage the deregulation of Japanese banks, which would make them for the first time customers for the high value-added rocket-scientist financial products we design in this country. We can't, they say, compete with the Japanese in commodity banking because they can underprice us, so we will live off our boutiques when their Ministry gives them the okay to shop. This is, I think, a good example of the trouble we are in, nationally. Banking is a business where you make money by blocking and tackling every day, but our best people don't want to do that any more. Given the history of our efforts to maintain our domination of the market for the sophisticated products we design, I beg leave to borrow from Bernard Shaw and say that my answer now abandons logical form and expresses itself by a gesture placing the thumb to the point of the nose and throwing the fingers into graceful action.

One is tempted to give the same reply to the contention that American interests will be best served by having five or six supergiant banks that operate all over this continent and can do bought deals with the cowboys in New York and London. The short answer is that the bigger they are, the

harder they fall. We already have inventories of swap transactions positioned by U.S. banks (who don't mark them to market) with loss potentials as great as the Latin debt. This is why the Bank of England and the Fed have begun worrying about capital adequacy, fourteen years after Walter Wriston and George Vojta (then at Citicorp) published their classic analysis of why in the modern world banks didn't really need any capital at all. If the people who run our money-center banks want to do bought deals in the Euromarket (or here, for that matter), and they can't surrender their banking license because they're insolvent, let them as individuals with rich friends start new corporations and raise the billions in capital necessary for that business, without the support of regulatory accounting and deposit insurance.

So far as banks qua banks are concerned, there is no evidence whatever that there are economies of scale. Indeed, the money center banks with maybe two exceptions show a poorer r.o.a. and r.o.e. than the regional giants--and even today, a $20 billion bank is still a giant. The Japanese banks get their money cheaper than ours not because they are bigger (an artifact of exchange-rate movements) and not because they are held to lower capital standards (in fact, counting the market value of the hidden reserves of common stock holdings they acquired thirty and more years ago, the Japanese banks have about twice the capitalization of the most heavily capitalized U.S. banks), but because Japan is a creditor nation and creditors pay lower interest rates.

Our bankers--and Treasury officials like David Mulford, who complained in Japan that someone must be doing something dishonest because Japanese banks got their money cheaper than American banks--were brought up to believe that America always had lower interest rates than other parts of the world. Gone with the wind, those days; and neither the creation of giant U.S. nationwide banks nor the award of new securities powers will bring the good times back. Quite the contrary, in fact: one of the reasons that all American money-center banks except Morgan have lost their AAA ratings in recent years is their dependence on government securities dealings and foreign exchange trading. The banks American investors like are Barnett and Fleet and State Street and PNC and Wells Fargo, who don't go whoring after foreign gods but do their work efficiently and profitably at home. It's hard to see how money-center banks selling for six and seven times earnings and less than book-plus-loan-loss-reserve will buy and pay for regional banks selling for twelve and thirteen times earnings and one and a half times book. Perhaps Mr. Gould's Treasury Department will help them. Congress, of course, should not, and I am confident will not.

What is most distressing about this concentration of attention on Glass-Steagall questions is that the real and important issues in the relations of banks and government go unconsidered. Our retail payments system, for example, is now on a Third World level by comparison with Europe, and despite the industry's enthusiasm for point-of-sale debit cards it will continue to fall behind. The Federal Reserve System today spends more money chartering airplanes to fly checks around the country every night--an entirely unnecessary activity--than it spends on electronic payments, and employs more people to process paper checks that should never come into a Federal Reserve Bank at all than it employs for all other purposes put together.

American corporations, banks and individuals are all to varying degrees hooked on float, and elaborate systems of cash management that try to take advantage of the inefficiencies of debit transfer payments absorb executive and engineering time and machine space that could scarcely be devoted to less socially productive uses. In all, we spend something like $20 billion to operate a payments system that could be run for something like half that sum, and the waste clearly diminishes our competitiveness against the economies of nations where direct deposit of payroll and pre-arranged debit of bills and bank giro systems are standard. In Germany, for example, the paper check is rapidly vanishing.

Congress is indeed in train to do something good by stealth in this area this year, through the device of a funds availability provision designed as a consumer measure, that will compel the banks to adopt check truncation and electronic communication of the information on the check. The State of Massachusetts has struck a major blow for modernizing our antiquated banking system by legislating lifeline banking, the free availability of basic bank services for poor people, because electronic banking and universality require each other. But the banks (and the Fed itself) go kicking and screaming into their brave new world; it's much more fun to think about competing with Drexel Burnham for M&A fees.

The possible--and it is possible--collapse of the wholesale dollar payments system, which now moves well over a trillion dollars every day, stands as a spectre that could devastate all the world's economies with one careless blow. President E. Gerald Corrigan of the Federal Reserve Bank of New York has sought urgently to call attention to this danger, which is especially pressing at Euroclear, where there is no lender of last resort to lubricate payments for or deliveries of Eurobonds. But nobody listens.

Finally, the question of how to control the money supply in an age of electronic banking has scarcely been addressed even by the regulators, let alone the Congress. Our established system of using the Fed's control over the creation of bank liabilities as the all-powerful mechanism has clearly come a-cropper in a world where even after taking action to control daylight overdrafts the Federal Reserve still supplies intra-day credit greater than the reserves kept overnight in the system. As more and more credit becomes securitized, the Fed's capacity to use monetary policy as a macroeconomic tool is grievously narrowed--quite apart from the fact that as a debtor nation we now impose great losses on ourselves, not just our friends and neighbors, when the Fed acts to raise interest rates to limit the creation of money through lending.

It is irresponsible of the bank regulators, the Treasury and the Congress to let such matters wait because big banks with big influence think (quite possibly erroneously) that they can make a few more bucks if they are allowed to deal in more paper and seek more fees. Public convenience, interest and necessity are not damaged by the workings of Glass-Steagall, and may indeed be benefitted, for the distinction between short-term and long-term money that is reinforced by the practical working out of the law speaks to the realities of the relation between money and the real economy.

Changing the law to increase the services banks can offer the public makes sense. Changing the law to let bank holding companies shoot craps with the high rollers--especially when their losses trigger government guarantees--makes no sense at all.

Statement of Thomas S. Johnson, President

Chemical Bank

before the Senate Banking Committee panel on Glass-Steagall

July 30, 1987

My name is Thomas S. Johnson, I am President of Chemical Bank, and I'm very pleased to be here today to participate in this important discussion.

I am sure that everyone in this room is familiar with the powerful forces sweeping the financial services industry. We know them as "globalization," "securitization" and "technology," and they are causing irreversible change in the financial services needed and demanded by individual and corporate consumers.

Given these trends, a rational regulatory framework would accommodate change -- would allow for innovations and encourage the system to evolve safely toward a healthier, more efficient condition.

In my view, this means a regulatory framework that enhances both the soundness and the competitive position of the U.S. banking system *and* enables it to serve the consumers of financial services.

Tragically, however, our regulatory framework does not do this: It is a maze of inconsistencies and bizarrely out of date.

On the subject of today's discussion, it's a sad irony that the Glass-Steagall Act -- which was passed to *promote* the safety and soundness of the banking system -- is today having exactly the opposite effect:

By preventing commercial banks from adapting to competitive challenges and customer needs, Glass-Steagall actually *weakens* their posture and renders them more susceptible to problems.

You can already see the early signs of trouble. The number of troubled banks is rising. Bank loans represent a steadily declining share of the nation's short-term commercial credit -- down from 75% just five years ago to 50% today. Return-on-assets at the money center banks has been in steady decline over the past decade and a half.

These are warnings that the laws and regulations governing the banking system need attention.

By "attention," let me emphasize, I do *not* mean special favors. Banks do not want or need a bailout, a subsidy, or protections. What they need is the opportunity to compete in the financial services marketplace on the same basis as other firms.

In my view, it comes down to this: If we want a healthy financial system, and if we expect our nation's banks to provide consumers with the best financial services, then we must maintain justifiable regulatory oversight, *and* permit banks to modernize their delivery of financial services.

If we don't, the consequences are likely to be a further weakening of the banking system.

Commercial banks based in the United States are being tested by global competition just as our auto-makers, steel factories and other manufacturers are. They are being tested by large _foreign_-based concentrations of financial fire-power -- such as that represented by Sumitomo Bank's $500 million investment in Goldman, Sachs.

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As of this year, only two of the largest 25 banks in the world are American, in terms of market capitalization.

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By contrast, Sumitomo Bank -- the Japanese bank with the largest market capitalization -- stands _first_, at $58 billion.

That extra size gives Sumitomo and other large foreign banks an advantage over our banks in engineering the multi-billion dollar deals so vital to our business today.

As president of a large U.S. bank, I know that our nation's banking system has the technology and talent to compete with anyone, anywhere.

In fact, a number of the most important innovations that are transforming global financial markets -- swaps, for example -- were developed by U.S. banks. We have the capacity to flourish as an industry; our nation's cities -- New York, Chicago, Los Angeles, Miami and others -- can be global financial centers -- but only if our laws don't limit our ability to compete.

Another challenge is the change in the nature of financial services needed and demanded by the American banking consumer.

Whether that consumer is a town mayor who wants the lowest cost of funding for a local project, a corporate treasurer who wants the cheapest source of operating funds, or the individual saver who wants to invest his or her savings in a diversified investment pool, the American consumer of financial services is demanding more than the local bank is allowed to provide.

This creates enormous pressure on commercial bankers -- and a great deal of frustration, I might add -- as we try to serve the needs of our customers.

After all, commercial bankers are still confined to the same basic savings products as in 1933. In the meantime, we have been challenged by mutual funds, savings and loans, insurance companies and other entities that offer

The CHAIRMAN. Thank you, Mr. Johnson.

I want to thank both you gentlemen for excellent, hard-hitting statements.

Mr. Mayer, I realize you may not be an expert on campaign finance reform legislation, but it relates to the subject of this hearing.

CONGRESSIONAL CAMPAIGNS ARE EXPENSIVE

It has been argued that a major reason we do not have agreement on a broader financial services holding company framework, is because congressional campaigns are enormously expensive, making the members dependent on huge campaign contributions from competing interest groups. This dependency, it is claimed, results in a legislative gridlock that obstructs a reasoned consideration of the issues that you are raising.

If the campaign finance situation could be corrected, the gridlock might be relieved and our banking laws modernized.

Mr. Mayer, do you agree with that assessment and the need for campaign reform legislation?

Mr. MAYER. As you say, I am not an expert on it. I was in Japan and was interested in what people said there about the role of political contributions by the securities houses and banks, the inability of the Ministry of Finance to do anything—it stands there like Balaam's ass—specifically, on the commercial paper issue. And of course, I had an op ed piece in the Wall Street Journal about the scandal of what the savings and loans people had been able to do in the Congress, in terms of preventing reasoned consideration of what this disaster is going to cost the American taxpayer and how the rescue is going to work.

I don't know what we do about that. It's a very serious problem. I served on President Reagan's Housing Commission, and we were a sunshine commission. We had to have all our meetings where people could be there, and somebody from this Senate committee, in fact, got hold of the Commission and said, can you guys sit down and see if you can get all these guys from the industry together, so we can have a piece of legislation. This was 1981, 1982, when the S&L's were going down the tubes for economic reasons and the housing industry was going down the tubes.

So we sat in the basement of the National Association of Home Builders in what was not an official meeting of the Commission, and we had the commercial banks, the S&L's, the builders, the realtors, all these guys come and talk, and we had a free an unstructured discussion, at the end of which I—I guess I was the one who closed it. I said, I am glad you guys are so pleased with what you got, because there are none of you who are willing to give up anything in order to get a more rational system for this industry and for the financing of it.

And I think that is true here too, that everybody is afraid to give up anything that he's got. I don't see Chemical Bank offering to give up the enormous benefits of regulatory accounting, when it talks——

The CHAIRMAN. I agree wholeheartedly with what you are talking about, but you see, they don't want to give up what they've got, and they make contributions to make it very, very hard for Congress to operate on that basis, and perhaps, hopefully, campaign reform might provide some limits that would make the Congress freer to act.

Mr. MAYER. Let me have one moment for a super anecdote, and I won't identify the Senator involved, who is an old friend. Back in 1979, I was doing a study by Twentieth Century Fund, which led to my book, "The Money Bazaars," sometime later, and it was already clear that the thrifts were in desperate trouble. And it was clear that the New York City savings banks were in terrible trouble, and Johnny Heimann, who was then Comptroller of the Currency, had a piece of legislation in his desk to do something to permit out-of-State acquisition of New York savings banks that might enable us to get through what could have been an even worse crunch than it was.

I mentioned it to my friend and we discussed it. He thought it was an excellent idea. He had interest in it. And as I was leaving, he said, "Martin, could you do me a favor?" I said, "What?" "Could you find out who would be against it," he said. [Laughter.]

And I suddenly realized that is what really happens in the world, and is affected by campaigns.

The CHAIRMAN. Mr. Johnson.

Mr. JOHNSON. Perhaps Mr. Mayer would permit me to speak for Chemical Bank. With respect to the regulatory accounting principles, we would be glad to go to a new regulatory system, new accounting system, that would reflect the securities business, and in fact——

CAMPAIGN REFORM LEGISLATION

The CHAIRMAN. Would you support campaign reform legislation?

Mr. JOHNSON. Sir?

The CHAIRMAN. Would you support campaign reform legislation?

Mr. JOHNSON. Oh, I'm not an expert on the cause-effect relationships, but if there is gridlock on this issue, there's enough gridlock on lots of others, that if that relationship is there, I would support it.

The CHAIRMAN. All right. Well, I don't know how much help I've gotten here, but——

Mr. Mayer, in your statement, you equate the appeal of Glass-Steagall with actions by several State legislatures allowing thrifts to make direct investments in real estate or equity securities.

I wonder if this is a fair comparison. There may be conflicts of interest involved in underwriting securities, but it does not seem to be inherently more risky than making commercial loans. If a bank is allowed to invest in a 30-year corporate bond, it does not seem unduly risky to allow an affiliate of that bank to hold the bond for 1 or 2 weeks during an underwriting period.

What risks do you see in underwriting corporate debt or equity securities that make it an unacceptable activity for a bank holding company?

Mr. MAYER. I think there are major conflicts of interest in terms of the—I think—if you hadn't had Glass-Steagall, the entire Third World debt situation would have developed differently, because they would have peddled this junk to the public as they did in the 1920's. That basic statement by the Federal Reserve that the temptation to securitize the worst assets will be there is—I think there is just no way to avoid that. That is going to be there. To have both the lending and the—and I think what we are doing now in terms of bought deals, by Salomon, by Merrill, by the people in London, is just enormously dangerous. I think that what we are doing in the swaps area, where we have people who are not marking to market in the banking business and assuming absolutely enormous risks, that the Aboriginal Bank of Alice Springs is going to be able to come up with floating rate Swiss francs when needed. [Laughter.]

These things are just—and we are insuring it, we are, as the taxpayers. I think it is folly. If I may given the last paragraph of what I didn't read.

Changing the law to increase the services banks can offer the public makes sense. Changing the law to let bank holding companies shoot craps with the high rollers, especially when their losses trigger Government guarantees—and we don't have insurance, we have guarantees, of course—that makes no sense at all.

The CHAIRMAN. Thank you, sir. Senator Heinz.

Senator HEINZ. Mr. Chairman, first, I would like unanimous consent to put a statement into the record.

The CHAIRMAN. Without objection, it will be printed in full at the opening of the hearing.

Senator HEINZ. Thank you, Mr. Chairman. I regret that I am going to have to leave for a markup in the Finance Committee on the Textile Bill, and I will reserve my time, but I am just not going to ask any questions right now.

The CHAIRMAN. Very good. Thank you. Senator Riegle?

Senator RIEGLE. Let me ask you, Mr. Johnson, you heard Henry Kaufman's assessment and recommendations, and so forth, and I realize you made a presentation that goes down a different track in certain respects.

CREATE A NEW REGULATORY FRAMEWORK

How do you react to what he said, generally? In other words, are you of the view that we need, maybe, to step back and create a new regulatory framework that really starts to size up the whole financial services business, and then also one that would be on an international scale that would start to deal with the internationalization of markets and capital requirements, and so forth, with some kind of consistent reporting mechanism? Did that ring any bells with you, or in your view, is that all just sort of cloud nine thinking and not really necessary or relevant to where you think we are?

Mr. JOHNSON. Senator, as you know, we have the belief that the financial markets, for historic reasons, chiefly relating to technology, are coming more and more together. To try to get that genie of separateness back in some kind of a bottle would be ridiculous.

I agree with a lot of what Dr. Kaufman has said. I would not have started with creating an oversight commission. If one is needed after you restructure the financial industry, fine. I would start with developing a set of principles for what the financial market realities today are and what kind of a financial system we need best to serve consumers, to promote safety and soundness and to promote competitiveness of our system throughout the world.

If an oversight panel, either domestically or internationally, then results from that, I would certainly be in favor of it.

I do not accept Dr. Kaufman's main point, and that is that there are inevitable and implicitly unmanageable conflicts of interest between lending, underwriting and equity investing, and if there are, there is so much of that going on today, that I don't know how this panel or anybody else could possibly unravel it.

So we have got to find an answer to that that can be managed.

Senator RIEGLE. When he talks about maintaining the division between commerce, generally, and banking, and then also investment banking from commercial banking, he makes that distinction.

On just the issue of commerce from banking, are you of the view that we have to—what are your thoughts on that? I mean, can General Motors come into the banking business, and should they, and can every other commercial firm now, if they should decide to come into the banking business, do you accept that, or do you think we need to think in terms of some kind of a dividing line between these two that we do try to maintain?

Mr. JOHNSON. My view is that that ought to be dealt with on a regulatory basis to make certain that where the public interest is viewed as being best served by having an SEC or a Federal Reserve or a Comptroller of the Currency regulate various types of business, that ought to be done.

With respect to General Motors, or Ford is probably even a better example, industry is already in banking. Ford Motor Co. owns one of the largest insured S&L's in the country. I don't think that people have alleged that the public is being harmed by that, and I certainly don't see any evidence of it.

Senator RIEGLE. And you have no problem with that?

Mr. JOHNSON. I have no problem with that

Senator RIEGLE. Mr. Mayer, let me ask you, George Gould has recommended that, basically, we ought to move in the direction of something like ten big banks in this country, and that there is a certain set of values and gains that we get from that, and the sooner there is the consolidation and sort of washout of a lot of smaller ones, and we get to these great big handful of major financial entities, that the better off we will be, both domestically, in terms of going head to head with the foreign competitors, and so forth.

Does that make sense to you?

MARKET CAPITALIZATION

Mr. MAYER. No. There are no economies of scale in this business. We are talking about market capitalization. The market capitalization of big boys like Chemical looks like it is going to fall behind people like Barnett and Sovran and PNC and people who have really moved into the late 20th century banking in ways that money center banks haven't, because they've gone for the M&A business.

The basic question which you asked earlier, if I may comment on it for a minute. I have a disagreement with Mr. Volcker and with Senator Proxmire on where the future is in this business. What we called banking was the agglomeration of transaction balances to be lent at interest. That business, which is what you distinguish from commerce, is dying and will die. There are two separate businesses in our future. One is the provision of payment services for a fee, and the other is the lending of money at a spread between what you can borrow it at with your credit and what the people who borrow from you can borrow it at with their credit.

These are not necessarily joined as historic banking has been joined. Now to the extent that the nonbank bank or the First Nationwide thrift is in the provision of payment services for a fee and does not want the deposits of the banks, then I see no objection to having nonbanks own it, particularly since it seems increasingly likely that the Federal Reserve is going to stand in the way of getting a modern electronic banking system in the United States. More than half of the employees of the Fed work in paper pushing.

We are now a Third World nation in electronic banking in this country, in large part because of the way regulation E has been handled, because of the way the Fed has prevented General Electric Co. from coming into the provision of automated clearinghouse services, because of the way our banks have resisted making the investment in the sort if giro electronic banking system that is quite common in Europe.

We have a $20-billion-a-year cost in this country for the operation of a payment system that can work for $7 or $8 billion. And it is a source, not a major source, but it is a source of our decline in competitiveness, by comparison, particularly, with the European continent.

Now to the extent that the intrusion of commercial companies into the provision of payments services is going to make a difference, I think there is a strong case for supporting it.

To the extent that what Sears wants is people's deposits or tie-in services, then it becomes a different problem. We will find out. If what they want is the fee for payment services, then the legislation that you have just passed on nonbank banks isn't going to make any difference, because they can do it on another chassis. If what they want is deposits, then they will go away. So I have no objection to the legislation. But I think that is one of the important issues that really has to be looked at when you look at the intrusion of nonfinancial companies.

Has technology really made a real change in the provision of banking service to the country?

Senator RIEGLE. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Wirth.

Senator WIRTH. Thank you very much, Mr. Chairman. Gentlemen, thank you very much for being with us this morning and for your great patience as you have sat through a great deal.

Let me follow, if I might, the same approach that I followed with Dr. Kaufman when he was here.

One, starting with kind of the base and the fundamental assumptions, which I attempted to identify as being twofold. One that our financial institutions are special, and that we do not want to treat them just like any other institution and deregulate them or, you know, assume that there is a level playing field out there, where they are treated just the same way as a drug stone chain might be.

And second, which I know you both might agree with, that we can't sit with the status quo.

I have heard you both say the former—agree with the latter. What about the former? Is there agreement that financial institutions are special?

Mr. **Mayer**. They are special to the extent that they use other people's money. To the extent that they perform brokerage services, they are less special, and that goes to the point that I was saying earlier, and particularly, because we insure deposits. I mean, this is the provision of the money supply, which is terribly important. What has been happening recently is that with the spread of securitization, the ability of the Fed to control the money supply is greatly diminished. There is such a thing now as a home equity account. Merrill Lynch started it, but now all the banks offer it too. If I can write a check on the value of my equity in my house, what is the money supply? What is a transaction balance? What is M1 or M2 or M3?

And this is a fundamental governmental function—the coinage. It is one of the things written in the Constitution for this Congress—to regulate the coinage. Wright Patman used to say that the Constitution told the House and Congress to regulate the coinage, and they farmed it out to the Open Market Committee of the Federal Reserve System.

It has been farmed out beyond there now. It is all over the place. It is extraordinarily difficult now for the Fed to perform a major governmental function because of the way technology has made it possible to turn assets that were once very unlike cash into cash.

Senator **Wirth**. Mr. Mayer, I appreciate that, but I am tempted to say, therefore, what do we do about it? The responsibility that we have is to try to figure out where we go from here.

Mr. **Mayer**. Where you go from here is where Henry Kaufman wants to take you, to really look at the way the world——

Senator **Wirth**. OK. And he assumes there is a special nature, and therefore, we treat these as special institutions. I mean, that is one of the basic assumptions that he comes in here with. And I just want to assure, first of all, we share that, that we are not dealing with, again, a drugstore chain or a used car lot.

Mr. **Mayer**. If it is other people's money, and if it is the money supply. Those are the two issues that make it a matter—that make these things special.

Senator **Wirth**. Mr. Johnson. It may sound like too basic a question, but I think it is fundamental to our ability to contemplate writing a piece of legislation.

Mr. **Johnson**. No, I don't think it is too basic at all, Senator. I would say that starting narrowly, that commercial banks are special by definition for two reasons. First, they do have the benefit of insurance. And therefore, they are certainly special with respect to the public purse.

Second, they are the mechanisms through which credit is created and monetary reserves are managed by the central bank.

With respect to those two issues, careful attention to how insurance is used and what it is insuring is certainly a very special and, therefore, a public interest matter, and likewise, as Dr. Kaufman suggests, the amount and the way in which credit is created is also special.

I would argue, however, that that does not necessarily mean that the instrumentalities through which those functions are performed need to be kept completely separate from other parts of the financial market. I would also argue that if they are special, you had better set things up in a way that they can make some money, so that they can stay in existence and perform those special functions over time.

RELATIONSHIP OF COMMERCE TO BANKING

Senator **Wirth**. That gets us to what is going to be one of the major areas of debate, and that is the relationship of commerce to banking. Separated out in Mr. Corrigan's proposal, separated out in what Mr. Volcker has testified on a number of occasions, separated out by Henry Kaufman's testimony. If they are special, we get to the next level. What do we separate out from this specialness, and what you are suggesting in answer to Senator Riegle's question, I understand, was that maybe we don't separate banking from commerce.

Is that right?

Mr. **Johnson**. I have not, despite a lot of research that I have looked at and asked our people to do, found the logical reasons why a separation on the ownership level between banking and commerce is necessary. I do think that some regulatory separation is necessary. It is there today with respect to Ford Motor Co.'s thrift, for example, and I have no reason to believe that we couldn't construct something that would keep it there in the future.

Senator **Wirth**. How does the proposed Bank Holding Company Act deal with this issue?

Mr. **Johnson**. The financial services holding company proposal that has been made by the Bank Holding Company Association and some others does not address the question directly of commerce and finance. And it is important to put in context that the interests of our industry are that we must reflect today's competitive position within the financial business and today's technology within the financial business.

If, as a result of historic developments that means that we have to get closer to commerce, so be it. We don't necessarily think that is a preferable way to go, but we can't find any real objections to it in our own analysis.

Senator **Wirth**. This is a final question. Why don't you address in that proposed legislation, this issue which has come up this morning?

Mr. **Johnson**. I think that it is not germane to the question of competitiveness and up-to-date technology in the financial business.

Mr. **Mayer**. If I may intervene for a moment on this. The guys who are killing the banks are the GMAC and the GECC's and the Westinghouse Commercial Credit and the people who have been able to operate in the middle market, which is the banks' natural innovative products that commercial banks aren't allowed to compete with.

A customer can come into one of our branches and invest his or her savings in a municipal bond. But if that customer wants to diversify risk and invest in a fund of municipal bonds, Glass-Steagall keeps us from creating and offering what he or she wants.

Small business customers are similarly hampered from getting competitive services:

They traditionally come to a bank for their financial needs; we lend them money for growth, know their businesses, manage their cash and provide other services. Yet when these companies become large enough to tap the corporate bond and commercial paper markets, they enter a realm forbidden to commercial banks and dominated by a cartel of securities firms.

Because of an antiquated law, we are not allowed to grow with them, to continue to serve our customers in meeting their expanding needs.

The rules are silly: U.S. banks can lend an American company short-term funds. But our right to facilitate a commercial paper issue for the same purposes is being fought tooth and nail by the handful of firms that have historically dominated that market.

We can lend money to a General Motors or other good customer here in the United States; we can underwrite and

distribute bonds for them abroad -- but we can't serve our own U.S. customers that way here in our home market.

That's neither logical nor efficient, especially in a globalized financial market, and it certainly doesn't help American companies get the best interest rates and overall service.

Nor American municipalities, by the way: In recent months, underwriting fees for revenue bonds -- where commercial banks are not allowed to compete -- have been $1, $2 or even as high $5 per $1,000 of par value over the fees for comparable issues of general obligations -- where banks do compete.

In all these instances, our clients are at the mercy of a handful of securities firms, while we are blocked from adding our competitive muscle to the marketplace. Because of a law that is, at best, outdated, the client loses.

Now, I can fully understand the motivation of firms that deploy considerable resources to maintain the status quo. Obviously, it is in their self-interest to resist any inroads into their protected business and to suggest dire consequences if banks are permitted onto their protected turf.

Five securities firms already control 90 percent of the commercial paper business.

Ten securities firms already have 90 percent of the $200 billion corporate security underwriting business.

They also control over 60 percent of the security industry's total capital.

Ten investment banks take nearly half the total pre-tax profits of the entire securities business in the United States.

Their professionals earn staggeringly high rates of compensation, and when compensation is included in operating earnings, the firms enjoy returns-on-equity in the forty-percent range -- a clear indication of just how much the securities cartel costs the American consumer.

You can see, therefore, why Wall Street is so fervently behind Glass-Steagall. But in the interest of consumers, it is obvious that banks should be allowed to join other financial firms in competing head-to-head across the full spectrum of financial services.

"New powers" is not the issue. The issue for the nation is how to have a financial system that reflects today's technology, today's consumer needs, and today's international competitive challenge.

For commercial banks, the issue is permission to engage in new forms of delivering traditional services.

There's nothing new about the municipal bond business, but revenue bonds are now over 50% of the market and -- on a technicality -- we're blocked from competing.

There's nothing new about short-term commercial funding, but commercial paper is the most efficient way to get funds to large firms today.

There's nothing new about Americans going to their local bank to invest their savings, but mutual funds represent an increasingly attractive way these savings are invested.

The fact is, there is a new reality out there in the marketplace -- the reality of technical change and international competition. You know it, I know it, and it is dangerous to ignore it.

We only harm consumers and the economy by retaining laws passed over 50 years ago in an era when bond prices barely moved, when there were no swaps, no NIFs, no RUFs, almost no municipal revenue bonds, no mortgage-backed securities, no Eurodollar deposits or any of the other revolutionary innovations of our day.

Instead of being continually, and piously, reminded that we must stay put and operate under the old rules -- American banks need the freedom to contend with the powerful forces transforming our world-wide industry.

In closing, I'd like to urge that our banking laws be shaped by a new public policy -- a policy aimed at benefiting the consumers of financial services instead of specific sectors of the financial industry, and a policy aimed at a U.S. financial system not hobbled in the international competitive arena.

The new public policy would mean a healthier, more diversified banking system -- based in the United States, not overseas -- and ensure better credit, transactions and payment services for America's future.

These benefits aren't going to come from some mysterious source. They are the natural benefits of free enterprise. They are the rewards Americans have come to expect when they substitute market forces for government fiat. They are worth having... and within our reach.

They can be achieved -- not through favoritism or protection of one sector of the financial services industry -- but through a simple recognition of reality.

Times have changed, and in order to keep up, Congress -- guided by the members of this committee -- should end the out-of-date and detrimental constraints on our banking system.

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turf today, without banking licenses, without supervision. And I don't know what you do about that in legislation. Now I think it's desirable that they not have access to deposits, but it's turned out that they don't need that. There's a strong case to be made that there's a considerable shake out needed in the banking business to improve the efficiency of the banking business, and that the extension of new powers of certain kinds—I have a list of things I think are very desirable—might impede that shaking out and might be bad for the country, and indeed, over time, bad for the banks.

It is by no means clear that we need giant money center banks in the United States at all. Not that that is what we should have only, but that we need them at all. Why the regional banks cannot do the banking business of the country, whereas people who are risking their own money rather than depositors' money do the other kind of business. I don't see that that's been proved or that it is, indeed, logically necessary.

Senator WIRTH. Mr. Johnson?

Mr. JOHNSON. Well, a brief comment. With respect to the middle market, if it is true, and I suspect that there is some merit in Mr. Mayer's statement about GECC, and so forth, getting into the middle market business, and if there are any constraints on the commercial banks, speaking for one which is probably the largest lender in the country between New York and Texas now in the middle market, we feel no undue competitive pressures, so long as we can be in the same markets with GECC. It is not really germane to the Glass-Steagall question of this hearing, but the biggest constraint that we operate under there is the lack of ability to operate across State lines.

Senator WIRTH. We have such a fundamental issue right here, even before we get to Glass-Steagall, before you get to the kind of regulatory outlines suggested by Mr. Corrigan or Dr. Kaufman. It illustrates the complexity of the task in front of us with this major commercial issue staring at us before we even begin to get to these other pieces.

The CHAIRMAN. Mr. Johnson, your bank isn't exactly a "mom-and-pop" operation. It is one big bank. It grew very rapidly, of course, in the last quarter, I guess, because you acquired the big Texas bank, too, and now your bank is $78 billion. That was the biggest merger, I take it, in the history of our country, wasn't it?

Mr. JOHNSON. Yes.

The CHAIRMAN. Now you say on page 3, "That extra size gives Sumitomo and other large foreign banks an advantage over our banks in engineering the multibillion dollar deals so vital to our business today."

Mr. Mayer disagrees. So does Chairman Volcker of the Federal Reserve Board, who we asked at some length about this.

I notice that the Japanese banks and Fortune magazine recently had a listing of the 100 biggest banks in the world. Their return on equity was less than the average of our banks, and only one of those—I should say, only 10 percent, only 1 out 10 of those banks had a return as high as the average return on equity as our banks in any size classification.

So measuring that as a standard of efficiency, which some people do, it looks as if size doesn't do it.

Mr. Volcker also pointed out that the most aggressive and successful international bank is the Bank of Tokyo, which is 29th biggest in the world, and one of the smaller of the major Japanese banks.

So why do you argue that you have to have a super size bank, bigger than $10 billion or $15 billion or $20 billion, to play hard ball in the international market. Isn't it true, as Mr. Volcker pointed out, that our banks are right at the cutting edge in the Eurodollar market? Our banks have done extremely well in competing with foreign banks?

What is the case for the big banks that Mr. Mayer has made a case against? What is the case for them?

Mr. JOHNSON. Well, Senator, first of all, I would start by saying that I simply don't agree with Mr. Mayer's comment that there are no economies of scale in banking industry.

The CHAIRMAN. I didn't expect you would.

Mr. JOHNSON. There are scale advantages. We have grown through acquisition. I don't want to bore you with the history of our acquisitions, but in every acquisition that we have made over the 19 years that I have looked at the place and the 160 years that our bank has been in existence, has resulted in economies of scale.

I think that one of the mistakes people who observe the numbers of our industry make is failing to recognize that there are so many competitive distortions inherent in an industry that's been sliced up by regulation, the way ours has, that perhaps statistics don't tell the true story.

We certainly have gotten lots of economies of scale in our business, and we are deriving lots more right now.

The CHAIRMAN. Well, let me just point out that the economies of scale don't seem to add up to a profitable operation. As I just said, our biggest banks have the lowest return on equity. The money center banks have a lower return on equity than our smallest banks have. That certainly is one measure of economy. The only scholarly studies I have seen, and I have seen several of them that have gone into this in meticulous detail, say that economies of scale, if they exist, stop at about $100 million. Now that was a few years ago, so maybe it is half a billion.

But you're $78 billion. Why do we have to have them even bigger still? Aren't there diseconomies of scale, when you have hundreds of branches, when you are moving all over the country, when you have centralized operations? Isn't it likely that you have a bureaucracy that can be almost as inefficient as the Federal Government?

Mr. JOHNSON. It would be hard to be that inefficient.

The CHAIRMAN. Well, that's right——

[Laughter.]

The CHAIRMAN [continuing]. But at $78 billion, you're on your way.

DISECONOMIES OF SCALE

Mr. JOHNSON. I think, Senator, that certainly, there are diseconomies of scale. There are diseconomies of complexity in running any large organization. There are also diseconomies in having to be coping continuously with the kind of change that is inherent in an environment resulting from changes in economic trends throughout the world

The Chairman. Can't the smaller banks change more easily, more quickly, than a huge ponderous bank, with tens of thousands of employees scattered all over the world? Isn't it hard to change under those circumstances?

Mr. Johnson. I don't think that would be borne out by the facts. I think also that with respect to the correlation statistics of small banks have a higher average return on assets, that probably relates a lot more to the situation that prevailed in my hometown of Racine, WI, where small banks had legislated monopolies, and smaller business there couldn't get their attention.

The Chairman. Hometown of what?

Mr. Johnson. Racine, WI.

The Chairman. Hey! No wonder you're so smart! [Laughter.]

I thought there was something special about you! [Laughter.]

You made the main point this morning. [Laughter.] I'm very impressed. [Laughter.]

Mr. Mayer, would you like to say a word on this?

Mr. Mayer. There are real arguments here on both sides. I did a study of what happened to Bank of America and saw diseconomies of scale in the most egregious form. I am not saying that Mr. Johnson's bank is in that sort of shape in any way, but it is true that in these big organizations—and banking is separate from commerce, to some extent—the management information systems do tend to be extremely difficult, and if you have people who have reasons not to wish the truth to get up top and indeed, we have seen this happen in the Government, perhaps it becomes difficult for people who are up top to find out what the hell is going on.

We are about to see a major improvement in return on equity at all the money center banks, because they are going to be allowed to calculate their earnings by comparison with the equity that is left after they write down the Third World loans. Everybody is going to look good next year.

It might also be worth taking a look at what is going to happen with the tax situation, if they can't get the Brazilian stuff back on line.

But all of these factors which get filtered in, which come up to Mr. Johnson's office in one form or another: They don't have a hell of a lot to do with what most people think of as banking. Either the machine is going to run in a reasonably efficient way, or it isn't. And if isn't, you are going to get in bad trouble. Inflation floats the boats. Deflation sinks them.

There's no strong reason to believe that the risks that are being taken in, for example, the swaps market, have really been calculated out.

The people who mark their swaps to market every day find that they have assets of fluctuating value. Banks, to my knowledge, I don't know about Chemical, the banks that I know about, do not mark their swaps to market every day, and therefore, it's like the process of getting old. You don't go down the hill, you just fall off the cliff every so often.

There is too much public interest in some of this, I think, to invite the taking of massive risks. And in general, in the financial business, the longer the term of the asset, the greater the risk. Term lending for banks is viable because the bank keeps up with the borrower.

I just worked with George Moore on his memoirs. Moore was the man who built Citicorp. George said that from the time when he was a lending officer, domestically, in the late 1930's through the end of his time at the bank in 1970's, he could think of only two or three of the corporations he had done business with that didn't need some sort of restructuring of their loans at some point in the game.

That is what Dr. Kaufman means when he talks about fragility. Once you get this in a bond, once you get it securitized, you have it down with an indenture, you have it down with something that is extremely difficult to change.

Bank relationships with borrowers are good for the country, just the way equity is good for the country, because you have a certain degree of flexibility and you have a cushion. The drive toward securitization is bad for the country over time, because it increases the rigidity and thus the fragility of financial structure. What you can do about it, I don't know. It should be studied.

But a number of these issues, which, it seems to me, are very big issues, and which are the things that underlie what Dr. Kaufman is talking about are really what the Government should be looking at now. In the meantime, I think we should extend the banks' powers to give services to their customers, but not worry all that much about whether we want to see them go out and gamble with the big boys in London or here on some of these more exotic matters.

They don't, with all respect, by and large, have the talent for it. And the dangers that are being run are very grave, and I think one does have to look, particularly, when you have an insurance situation, and when that has been extended in the Continental-Illinois matter, and when you are facing—you know, people say FDIC has saved the banks. Well, maybe FSLIC has saved the thrifts, but it ain't saved the Congress or the Treasury.

These things are tricky, and if the Government is going to be involved as an insurer, the Government should keep a very good eye on the assets. I do not believe you can really insulate a security subsidiary that has the same name from the bank you insure. The British say the grapevines grow over Chinese walls. More than grapevines grow over Chinese walls.

The CHAIRMAN. One quick questions for Mr. Johnson, before I yield to Senator Sanford.

FOREIGN BANKS TRIPLE THEIR LOAN BUSINESS

Since 1973, foreign banks have almost tripled their share of the U.S. commercial loan business. They now have 22 percent.

What is the reason for that? I pointed out, their return is less. How are they able to move into our market, compete and take away three times as much of our loans as they did 13 years ago?

Mr. JOHNSON. I think a simple reason for that, Senator, is that they compete across a very narrow part of the full financial spectrum, and I don't believe that we ought to try to stop that. They don't come in and try to serve their clients across-the-board. They are not the home bank for U.S. companies. They come in and skim the cream of the crop. And I think that is fine. And we do that around the world as well.

The CHAIRMAN. Thank you. Senator Sanford?

Senator SANFORD. Well, it's quitting time, Mr. Chairman, and I want to thank both of these witnesses. I have read their papers very carefully. I have had two staff people here, and I apologize for not having been here myself, but that is the way conflicts work.

I would ask just one question of Mr. Mayer. You talked about the ability of banks to adjust their balance sheets between their investment paper and doubtful assets so that they end up looking like they are better capitalized than they are, but do you think that we need to strengthen or modify the accounting rules for banks to make certain that we get the proper capitalization?

Mr. MAYER. Yes. I very definitely do. I would strengthen other accounting rules too, but certainly with regard to banks, yes.

Senator SANFORD. With that kind of dealing with deposits, and you also talked about that, I just saw one interesting little bank product that a California bank recently introduced. Perhaps there is something about the California climate. You can make a CD deposit, a Certificate of Deposit in the bank. That is tied to select previous metal indices and that it is guaranteed by FDIC.

Now is that sound bank or is that speculation? Is that getting over, under and around Glass-Steagall in any indirect way?

Mr. MAYER. It is an abuse deposit insurance. We have also got, you know, we've got returns that are based upon what happens in the stock market. We've got all of these new products which relate to CD's. In some ways, it's less bad than what the S&L's have been doing, which is paying people 250 basis points over market guaranteed by the Federal Government. At least in this paper, the Federal Government isn't guaranteeing the interest.

Senator SANFORD. Only the underlying spread.

Mr. MAYER. That's right. Whereas in some of the other products that we have seen them put out, you put the credit of the U.S. Government behind preposterous interest, which they can earn only by taking extremely risky investments. That is the California and Texas situation.

Senator SANFORD. But what about the tendency to use CD's for different purposes?

Mr. MAYER. I have some sympathy with Mr. Johnson's view that the banks—that we really do have a Lilliputian situation here with Gulliver, in that banks squirm and wriggle so to get out from under a lot of very detailed and small and trivial and very poorly administered regulations, that when they find openings, they tend to burst through them.

Some clever fellow found an opening in the CD, where the earnings could be tagged to something else, and the banks have been running through it. I think it is unfortunate, it is unwise. It also sort of trivializes the relationship between banks and their depositors and borrowers, and I think those are important relationships. But, frankly, to be honest with you, while I don't like it, I am less disturbed by this paper than by the thought that Vernon Savings & Loan is paying 9½ percent to people through money brokers, and the Federal Government stands behind their paying that interest.

Senator SANFORD. Well, we, of course, are concerned with both of those things.

And again, I want to express my appreciation to the very substantial contribution that both of you have made to these deliberations.

Thank you again, for being here.

The CHAIRMAN. Well, I certainly join in those congratulations. You've been very wise and helpful witnesses. We appreciate your testimony very, very much.

The committee stands adjourned.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

[Response to written questions and additional material supplied for the record follows:]

Department of History
(213) 743-2368

August 21, 1987

Senator William Proxmire, Chair
Committee on Banking, Housing, and Urban Affairs
United State Senate
Washington, DC 20510-6075

Dear Senator Proxmire:

I was honored to be able to testify before the committee regarding the origins of the Glass-Steagall Act on July 30.

I am returning answers to the questions forwarded to me from Senator Terry Sanford. I have provided two versions: a short, direct answer plus a slightly expanded version. I hope these responses prove adequate; if not, I will make a second effort.

I am sorry that other business called you away during my ten minute oral presentation to the committee because I wanted you, in particular, to hear my closing remarks:

> I believe the key question centers on whether the repeal of the divorce provision would lead to more competition in the investment banking field and the emergence of a less oligopolistic market structure. For that to happen, regional markets would need to be more fully developed--in Chicago, Los Angeles, and Atlanta, plus to a more limited extent in maybe another ten or so cities across the nation. To achieve that outcome in the investment banking market, which has been traditionally oligopolistic for over 125 years and geographically centered in New York and Boston, it might be necessary to delay for a period of five years or so the involvement of all commercial banks presently headquartered in those two cities. Applying an "infant industries" argument, commercial banks with strong regional name identification might be give a modest headstart toward the goal of creating a more geographically dispersed and less concentrated U.S. capital market. I see nothing wrong with that development and much to recommend it.

If you or the committee needs any more assistance, please call on me again.

Sincerely,

Edwin Perkins

Edwin J. Perkins

UNIVERSITY OF SOUTHERN CALIFORNIA
University Park
Los Angeles, California 90089-0034

QUESTIONS OF SENATOR TERRY SANFORD
FOR DR. EDWIN J. PERKINS

Q.1 If laws prohibiting the manipulation of stock between bank and securities affiliates, as promulgated in the Securities Exchange Act of 1934, had been in place in 1930, do you believe we would have seen the inclusion of the four Glass-Steagall provisions in the Banking Act of 1933?

Question #1. The short answer. No. I do not believe the divorce provision would have been included in the Banking Act of 1933 if laws prohibiting the manipulation of the stock market, as enacted in the Securities Exchange Act of 1934, had already been in place. Those laws would have been fully applicable to the security affiliates of commercial banks and almost certainly would have cleaned up any and all abuses.

The longer explanation. When Glass was drafting his bill, he had no firm knowledge regarding the ultimate effect of the SEC and all related laws on the operations of the securities industry. For all he knew, the whole SEC movement might prove a complete flop for a host of reasons. (Remember too that he was very skeptical about the FDIC--that was Steagall's main contribution to the bill.) In order to make absolutely certain that commercial banks and their customers would be protected, Glass believed drastic surgery was required. The best evidence, however, that Glass subsequently had second thoughts is the fact that he himself was a leading spokesperson for the voting majority in Congress who wanted President Roosevelt to agree to a repeal of the divorce provision during the deliberations over new banking legislation in 1935. But FDR was adamantly opposed to any change in the 1933 law. By that date Glass had an opportunity to see that the SEC was capable of performing its assigned task. His doubts were allayed. Or to put it another way, there is no question in my mind that if the Glass-Steagall bill had been drafted in 1935 or 1936 rather than in 1933, it would have included no divorce provision. The chronology relating to when these bills were enacted had a very important impact on the final wording of their various provisions.

Q.2 It is my understanding that Carter Glass, in crafting his separation legislation, was operating from two main premises:

a) Banks in the 1929-1933 period were failing largely due to the underwriting and dealing activities of their securities affiliates.

b) Banks were helping their securities affiliates sell large volumes of unsound securities to their downstream correspondent banks which was in turn a major cause of the collapse of the U.S. banking system.

Do you believe that these were the premises Senator Glass was relying upon? If so, were these premises an accurate reflection of the situation.

Question #2.

The short answer. Yes, these were some of the ideas that Glass was relying upon in formulating his legislation; he did believe that the activities of security affiliates were among the leading causes of bank failures and also for the general collapse of the banking system. But careful studies by economic and financial historians of the operations of the banking system in the 1920s have shown conclusively that Glass's premises were grossly in error.

The longer explanation. The techniques of economic analysis have advanced dramatically over the last half century. Glass and his academic advisors were operating under two serious handicaps. The first was the totally flawed "real bills" doctrine; second, they made their judgments on the basis of impressions about events--never basing their judgments on any genuinely systematic analysis of banking data.

The banks that had security affiliates were not the banks that were failing in the early 1930s. The major New York banks which were heavily involved in corporate underwriting were not the institutions going under in droves. Instead, the failed banks were repeatedly undercapitalized institutions in rural areas. Their failures were linked to falling prices for agricultural products. Take your own state of North Carolina. Bank failures there were the result of farmers' inability to repay crop loans and farm mortgages because of the low prices for tobacco, grain, and livestock. Banks in North Carolina did not fail in the early 1930s because their New York correspondents had foisted upon them hundreds of unsound securities. The only proof in that regard was Glass's constant assertions that there was some imprecise but allegedly real connection between the actions of the security affiliates of large urban banks and failures all across the country, including North Carolina and other rural areas. It was a case of unquestioning faith prevailing over all evidence to the contrary. Moreover, while Glass could never generate solid statistical data to support his contentions, his opponents were never able to refute the all-encompassing allegation that there might be some hidden connection between events on Wall Street and problems connected with maintaining the solvency of rural banks in farming regions. If Glass wanted to place much of the blame on New Yorkers for the troubles in your state, few local people were likely to come forward to absolve the big city bankers of any responsibility.

Admittedly the article makes for somewhat dry reading, but before making any final judgment about this whole matter of separation, I would urge you and your colleagues to spend 30 minutes reviewing the one academic article I mentioned during my testimony. The citation is: Eugene Nelson White, "Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks," Explorations in Economic History, Vol. 23 (1986), pp. 33-55. If you had to read just one study related to this question, I would put this one at the very top of the list. White is an extremely competent scholar; he owes no allegiance to any special interest. His study was motivated strictly by intellectual curiosity. He is completely credible and believable.

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If you have any further questions, or any more later arise in the minds of your colleagues on the committee, please do not hesitate to write to me again.

QUESTIONS OF SENATOR TERRY SANFORD
FOR DONALD A. RITCHIE

Q.1 If laws prohibiting the manipulation of stock between bank and securities affiliates, as promulgated in the Securities Exchange Act of 1934, had been in place in 1930, do you believe we would have seen the inclusion of the four Glass-Steagall provisions in the Banking Act of 1933?

A.1 The Glass-Steagall Act of 1933 and the Securities and Exchange Act of 1934 addressed different problems but were philosophically consistent. The authors of both bills considered the inflation of bank credit for stock speculation, and the reckless behavior of investment bankers in the 1920s, to be major contributors to the stock market crash and depression. The Glass bill did not attempt to regulate investment practices, but instead ordered commercial banks out of the securities markets. As Senator Glass explained during Banking Committee hearings in 1932: "People who want an investment banking system are at liberty to organize one and have organized one. The Federal reserve system is a commercial banking system. Its assets should be liquid. It should be amply able and cheerfully willing at any time to respond to the demands of agriculture, commerce, and industry, and that can not be if it is going into the investment banking business."

By contrast, the Securities and Exchange Act provided for federal regulation of all stock exchange operations, sought to delineate the proper role of investment bankers and brokers, and attempted to prohibit the manipulation of stock prices. The SEC Act also gave the Federal Reserve Board authority to regulate the use of credit in financing the trading of securities.

Although Senator Glass played a critical role in shaping the final version of the Securities and Exchange Act, he was not its principal author. Historians have assigned chief credit for the act to three members of the Roosevelt administration, James M. Landis, Benjamin V. Cohen, and Thomas G. Corcoran, who assisted the Senate and House Banking committees. While these three men were as liberal as Senator Glass was conservative, they agreed with him on the need to limit the role of the banks in the stock markets. Landis, Cohen and Corcorcan had been influenced by the ideas of Louis D. Brandeis, as expressed in his book, *Other People's Money: and How the Bankers Use It*. The authors of the Securities and Exchange Act certainly figured the provisions of Glass-Steagall into their calculations. Had they drafted the Securities and Exchange Act before passage of Glass-Steagall, it is reasonable to assume that they would have taken an equally restrictive stand on the role of commerical banks in the securities markets. The histories of these bills do not suggest that the regulatory mechanism created under the Securities and Exchange Act would have negated the government's interest in separating commerical and investment banking functions.

Q.2 It is my understanding that Carter Glass, in crafting his separation legislation, was operating from two main premises:

a) Banks in the 1929-1933 period were failing largely due to the underwriting and dealing activities of their securities affiliates.

b) Banks were helping their securities affiliates sell large volumes of unsound securities to their downstream correspondent banks which was in turn a major cause of the collapse of the U.S. banking system.

Do you believe that these were the premises Senator Glass was relying upon? If so, were these premises an accurate reflection of the situation.

A.2 Senator Glass did not blame the bank failures of 1929 to 1932 solely on the underwriting and dealing activities of their securities affiliates, but he believed that these practices had weakened the American banking system.

During the hearings and debate on his bill in 1932 and 1933, Senator Glass offered several reasons for separating commerical banking and investment affiliates. These were: 1) to discourage banks from providing excessive credit for stock speculation; 2) to channel bank loans back to more traditional areas of investment; 3) to prevent bank portfolios from filling with unsound stocks; 4) to prevent banks from lending their "name and prestige and tradition" to securities affiliates that offered no protection for the interests of their customers; 5) to correct bank mismanagement; and 6) to restore public confidence in the national banking system.

Senator Glass drew his premises from extensive hearings in 1931 and 1932. He noted that his subcommittee "had not acted in a whimsical way but has for weeks after weeks gone over these matters with the utmost care and sought the advice of experienced and tested bankers and experts." The subcommittee also distributed questionaires and compiled extensive statistics on banking practices in the 1920s.

The Banking Committee's report on the Glass bill, issued on May 17, 1933, found that "public opinion was in an indeterminate condition" on the whole subject of banking reform. However, at the same time the Pecora investigation was producing daily headlines on the practices of bank security affiliates in the 1920s. These hearings, in which Senator Glass participated only minimally, uncovered evidence that banks had used their affiliates improperly, to unload weak stocks and bail out bad loans. Such revelations had a direct impact on public opinion, and on congressional and presidential support for the Glass bill. The Pecora investigation produced impressive evidence for its charges of banking abuses, which in turn bolstered the arguments for the Glass-Steagall Act. Therefore, the premises on which Senator Glass, the Banking Committee, and the Congress acted were based on a fully documented examination of the situation that existed prior to 1933.

The following excerpts from Senator Glass' comments and questions indicate his thinking on these issues:

1) Senator Glass. The purpose of this bill is to avert a repetition of the present status. You say you are in favor of cutting out loans for others, which reached a peak of some eight billions of dollars during the riot of speculation. You say you are in favor of cutting them out. Wouldn't you regard that as deflationary?

Mr. Pope (representing the Investment Bankers' Association). I wouldn't if they were in. But they are not in.

Senator Glass. But they might come in again.

Mr. Pope. I do not think they will.

Senator Glass. There isn't anything in this bill that deflates anything right now, except stock gambling, which has abated tremendously.

(Senate Committee on Banking and Currency, Operation of the National Federal Reserve Banking Systems, Hearings on S. 4115, 72nd Cong., 1st sess (Washington, 1932), 23.)

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Senator Glass: The main purpose of the bill as passed by the Senate last spring, as Senators will recall, was to prevent, under penalty, the use of Federal Reserve banking facilities for stock-gambling purposes." I use that term in its harshest sense, realizing that it touches the sensibilities of a great many people who persist in calling it "stock-investment purposes." But it is not stock-investment purposes because no man ever yet invested his money and found it necessary to keep his ear to the ticker to find out what was going ot be the price of stocks the next hour or day or week or month. It is nothing in the world but pure gambling just as much as that at Monte Carlo. The New York Times, priding itself as an organ of the interests, or a spokesman of the interests, stated that 90 pecent of the activities of the stock exchange in 1928 and 1929 consisted just as much in gambling as betting on the arrow of the roulette table. The bill as passed by the Senate undertook, under moderate penalty, but I think effective penalty, to put a stop to that sort of thing, and so does this bill.

The bill as passed by the Senate last spring required the separation of investment affiliates from member banks of the Federal Reserve Banking System, investment affiliates that were the largest contributors, next to the gambling on the stock exchange, to the disaster which was precipiated upon the country in 1929.

(Congressional Record, 73rd Cong., 1st sess., May 19, 1933, p. 3725.)

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2) Senator Glass: What the committee had in mind was to guard against unsound banking. What the committee had foremost in its thought was to exclude from commercial banking all investment securities except those of an undoubted character that would be surely liquidated; and for that reason we made an exception of United States securities and of the general liabilities of States and subdivisions of States.

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For example, I recall right now, in my own State, a little town not far from my own home town which had a vote of the people and decided upon a bond issue for waterworks purposes. It appled to investment houses in various money centers to take these 6 per cent bonds. None of these investment houses would take them. . . . We did not think securities of that nature, for special purposes, ought to crowd the portfolios of commercial banks; so that our whole purpose was to guard against investment securities in national banks, which are supposed to be strictly commercial banks, responsive to the immediate requirements of that community.

(Congressional Record, 72nd Cong., 2nd sess., January 19, 1933, p. 2092.)

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3) Senator Glass: Because our exhaustive investigation disclosed the fact that so many national banks had failed because they had filled their portfolios with unwise and practically useless investment securities; for that reason we tightened the matter up, but I do not object to tightening it up a little more.

(Congressional Record, 72nd Cong., 2nd sess.,January 24, 1932., p. 2406.)

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4) Senator Glass. You loan the name and prestige and tradition of your national bank to your /securities/ affiliate. Is your national bank responsible for all the losses that may offer in the operation of your affiliate?

Mr. Pope. Not at all.

Senator Glass. Don't you think it ought to be?

Mr. Pope. I should not think so. We do not intend it to be so.

Senator Glass. You loan to your affiliate, as I say, the prestige and tradition of your sound national banking institution. People buy its investment securities perhaps largely on that basis, and yet if a failure should come. . .it seems to me there ought to be some responsibility on the part of the bank.

(Operation of the National and Federal Reserve Banking Systems, 34.)

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5) Senator Glass. Do you mean to say there is no distinction between commerical banking and investment banking?

Mr. Wolfe (representing the Association of Reserve City Bankers). There is a great deal of distinction. Commerical banking is one thing, and investment banking is another thing.

Senator Glass. One would suppose they should be, but they are not.

Mr. Wolfe. They are in good, well-managed banks, of which I am glad to say we have a majority in this country.

Senator Glass. But we are trying to correct the evils of mismanagement of banks.

(*Operation of the National and Federal Reserve Banking Systems*, 267.)

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6) Senator Glass. Do you think they /investment affiliates/ should ever have become tied up with commerical banking institutions?

Mr. Hecht (representing the American Bankers' Association). Senator Glass, may I answer your question this way? If the bill presently under discussion were a bill that we might all consider for the purpose of starting the ideal banking system on a fresh basis, then there would be a good many provisions in it which I would strongly favor. But under existing conditions, and because of the difficulty and the harm that would come from their enforcement I am now opposed to them. In other words, it is one thing to have a opinion whether banks should ever hafve gone into the investment business in the past, and it is another question whether we should now, by one swoop of the law, try to unod something that has grown up over 20 years of banking practice. . . .

Senator Glass. Then, I assume your theory is, if an evil practice of long standing has associated itself with the banking business, it ought never to be corrected?

Mr. Hecht. No. I would not make any such statement or demand. And I have not admitted that it is an evil pracitce. I have stated that it is the abuse of the practice that has justified criticism now being leveled at it, and that requires perhaps some additional legislative control. . . .

Senator Alben Barkley: When would you be willing to begin corecting such evils as you admit exist in the present banking system?

Mr. Hecht. There are perhaps, some that might be well corrected rather promptly, but such important questions as the control of real estate loans, control of loans on collateral security, and measures of that kind, that are undoubtedly deflationary, will add to our present troubles, which in my judgment would not be discussed or at least enacted at this time, but should await a return, not to another boom period but at least to a more normal period in banking, when general confidence is not already shaken as badly as it is now.

Senator Glass. You do not think we ought to correct things that have shaken public confidence?

Mr. Hecht. I do not think we should do anything that will lengthen the present depression, that will continue or add to the fear and hysteria on the part of the general public that already exists.

(*Operation of the National and Federal Reserve Banking Systems*, 231-232.)

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